

**CEE HOUSING LOAN RECOVERY
COLLOQUIUM PROCEEDINGS**

&

**MAXIMIZING HOUSING LOAN
RECOVERY**

**LESSONS FOR CENTRAL AND
EASTERN EUROPE**

Prepared for



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CEE Housing Loan Recovery Colloquium Proceedings

I. Executive Summary

The CEE Housing Loan Recovery Colloquium was held in Budapest at the Hotel Gellért on December 16 and 17, 1996. Approximately 50 participants from 8 countries attended. The main participant countries were Hungary, Slovakia, and Croatia, composing about three-quarters of the total number of participants. Representatives from other CEE and Western European countries also attended, including Poland, the Czech Republic, Germany, and France, in addition to the U.S.

A) *Purpose of the Colloquium*

The purpose of the colloquium was to provide an international exchange of implementation and policy experience on housing loan recovery in Central and Eastern Europe. This is a part of mortgage lending that most countries in the region need to strengthen.

B) *Participant Countries*

The colloquium was organized specifically to provide an opportunity for participants from three CEE countries -- Hungary, Slovakia, and Croatia -- to exchange information among themselves and other counterparts from the CEE region and Western Europe and the U.S. From each country there was a mix of delegates representing the banking sector, government ministries dealing with housing finance issues, the courts and legal systems, and housing research and technical assistance institutions attended the colloquium thereby providing a broad basis for discussion. In addition, representatives from Poland and the Czech Republic attended to serve as additional resources for intra-regional learning. Banking and policy experts from France, Germany, and the U.S. made presentations at the plenary sessions and participated actively in plenary and breakout discussions to provide perspectives from established market economies.

C) *Structure*

The colloquium was organized in a such a way as to provoke discussion and exchange of information. The proceedings were broken into three topics: (1) The Legal Basis for Residential Mortgage Loan Recovery, (2) Maximizing Housing Loan Recovery—Alternati Foreclosure and Eviction, and (3) Other Mechanisms for Managing or Reallocating Risk. After presentations to the plenary session and general questions and answers on each topic, a panel of experts from different countries responded to the presentations with brief remarks, and plenary discussion ensued. Participants from each of the three participant countries then gathered separately to discuss issues provided by the moderator within the context of their current situation. During the third and final

breakout session, each country group attempted to achieve some consensus on the major barriers in that country to effective loan recovery and tried to agree on the most important and immediate “future directions” to strengthen loan recovery and housing lending.

II. Overview

Opening remarks were made by Ágnes Balázs of the Hungarian Ministry of Finance and Larry Birch of USAID/Hungary. Ms. Balázs emphasized both the similarities and differences among countries in CEE in the current period of political and economic transition. Loan recovery is a part of this transition process, and economic factors and social behaviors are currently not favorable in this regard. Hungary’s economic transition suffers from low housing mobility which is due to a variety of reasons, including the high cost of housing, reluctance to move, and difficulty in obtaining a loan. Ms. Balázs encouraged the participants to take advantage of the gathering of experts from many countries to try to find some answers to these dilemmas.

Larry Birch spoke about housing loan recovery as an uncomfortable problem across the region given cultural attitudes towards housing as a social right. In the long-run, Mr. Birch stated, the goal should be to protect attitudes towards credit, in other words, the “credit culture,” as the way to improve loan recovery. Several dilemmas regarding loan recovery can be described, and should be discussed at the colloquium, including the development of the credit culture vs. social rights, the best intentions of those taking out loans vs. the reality of unemployment, disability, or other reasons for default, and exclusivity vs. wider access to credit. The broader endeavor should be to create a fair housing finance system, accessible to the largest number of people possible. The only way to accomplish this, Mr. Birch said, is to make housing finance a good business; and reliable loan recovery is the cornerstone to that business.

Douglas Diamond next gave an overview of the colloquium (see Annex A). Mr. Diamond argued that in order for a lending system to work properly, the party making the loan (the banks in the case of housing finance) must be very confident that it will be paid back in a timely way, as agreed. In order for that to happen, effective and reliable loan recovery mechanisms must be in place. Mr. Diamond described an effective recovery system as one in which the borrower is certain of the ultimate consequences of non-payment of the loan: that he will lose the house financed by the loan in some reasonable amount of time. Without a reliable system of loan recovery, lending for housing in CEE or anywhere will not develop fully and housing opportunities for large numbers of citizens will be significantly reduced. Mr. Diamond then gave a brief overview and description of the colloquium structure, and voiced the desire that the colloquium help in the formulation of realistic plans to strengthen loan recovery in all the participant countries.

III. Topic 1: The Legal Basis for Residential Mortgage Loan Recovery

A) Dr. Olga Hildebrand

Ms. Hildebrand gave a thorough historical overview of loan recovery in Hungary, dating back to 1871 when execution of the enforcement of liens was first sanctioned in Hungary's court system. A series of amendments and decrees were added over the following 74 years until 1945, which generally served to simplify and speed up procedures. During the socialist period, there was officially no need for laws of this sort since it was expected that people would "voluntarily" pay back any loans given to them by the state.

The legal framework for loan recovery in the pre-1945 period permitted foreclosure through a court procedure. The lien was registered in the land registry, and had first priority against all other claims on the property. Foreclosure could not take place without clear documentation of the property's legal status in the land registration system. The system followed closely the German/Austrian system at that time, including a preemptive right of purchase by the state in case of foreclosure and a minimum bidding price of 2/3 of the established property value.

According to Ms. Hildebrand, during the socialist period, garnishment of wages was the principal mechanism used to recover loans. This mechanism is not satisfactory under current conditions when a lender can no longer assume that a borrower is employed by the state, and the new legislation resulted from the need to accelerate foreclosure procedures. Under the current legislative framework, foreclosure can proceed on the basis of either a court decision or solely on the basis of a notarized contract between the bank and the borrower. With notarization, the bank can obtain an enforcement order and avoid a lengthy court procedure; without it, there is no way to foreclose without going through the courts. Banks, though, are no longer able to automatically attach wages in case of default. In addition, termination of the loan agreement in the case of default is complicated in the event that other claims are also registered. Proceeds from an auction are allocated according to other claims, and bank claims are preceded by public liability claims, even if those claims are not secured by a lien.

Ms. Hildebrand noted some recent amendments to the Civil Code which allow the sale of pledged property jointly by the borrower and creditor without participation of the courts. At the end of foreclosure proceedings, all liens on the property cease and the right of pledge is eliminated. Finally, Ms. Hildebrand clarified that in the event of foreclosure, the borrower must return the property to the lender vacant or as stipulated in the loan agreement. The significant legal changes in the loan recovery area adopted during the past several years need to be tested in practice in order to improve the predictability and reliability of the system.

B) Carol Rabenhorst

Carol Rabenhorst spoke on the topic of “Establishing the Legal Basis for Housing Mortgage Loan Recovery.” Ms. Rabenhorst described the costs of mortgage default on all players in the housing finance system, including lenders, institutions that insure loans, borrowers, and the system as a whole if collective defaults reach a high level. Lenders have a number of choices available to them in case of default, and can choose to wait and see if the borrower begins to repay, negotiate different loan terms more affordable to the borrower, or take legal action to recover the loan.

Ms. Rabenhorst mentioned some reasons why a strong legal framework is necessary for loan recovery. Strong laws are a backstop for nonpayment, even if rarely used, and they deter nonpayment since they clearly state the consequences on non-payment. As a corollary, weak laws increase the cost of loans since the increased risk of default must be compensated by higher costs to the borrower.

The necessary components of the legal framework can be broken into enabling laws, registration laws, and enforcement laws. Enabling laws provide that a mortgage is a property right that can be used to secure a lender’s claim for payment of a debt. Registration laws provide a system to demonstrate ownership or title and the existence of others’ interests or property rights. Enforcement laws regulate the procedures under which the lender may pursue remedies for default.

Ms. Rabenhorst described the progress to date in reforming the legal framework in CEE, starting with a summary of pre-transition legal issues and basic weaknesses in the legal framework. She generalized recent changes across CEE including the elimination or expedition of judicial procedures, alternative housing requirements, execution procedures, and efforts to improve registration procedures. Ms. Rabenhorst then briefly explained some alternatives to foreclosure and eviction which the legal framework allows in the U.S. and elsewhere, including forbearance and renegotiation, voluntary sale of property, assumption of mortgage, deed in lieu of foreclosure, garnishment of wages, and third-party guarantors. She concluded that substantial progress has been made in recent years to improve laws which strengthen loan recovery, and that CEE countries will continue to harmonize their legal framework with that of the European Union.

IV. Topic 2: Maximizing Housing Loan Recovery -- Alternatives to Foreclosure and Eviction

A) Denis Deletoille

Denis Deletoille of Union de Crédit pour le Bâtiment (UCB) in France gave an overview of loan recovery mechanisms in France as an alternative to foreclosure and

described the operations of UCB, a residential and commercial mortgage loan recovery operation in France. Mr. Deletoille described UCB as a large company of over 1,800 employees founded in 1951. The company has FF 62 billion in outstanding loans and a 6.3 percent market share in France. Mr. Deletoille then provided some information about the housing finance market in France, such as the fact that 78 percent of home buyers need a mortgage loan to finance their purchase, fixed and floating rate instruments are available, and 40 percent maximum payment to income ratios are allowed (including 10 percent consumer debt).

The legal environment for loan recovery in France is governed by two laws, Scrivener I (1978) and Scrivener II (1979). These laws regulate the loan contracts and conditions of withdrawal from the contract. They also regulate penalties and remedies in case of delinquency and default. The Neiertz Law protects over-indebted borrowers by establishing a national database on defaulters and providing special treatment of these borrowers to ease rescheduling of debts and encourage fair treatment. Legal actions in the case of default include foreclosure, which has a minimum cost of approximately \$3,000 and a duration of at least 16 months.

In order to maximize housing loan recovery, UCB focusses first on the recovery process itself, which is governed by the following objectives: to keep the loan “alive” (to avoid a total lapse of payments); to recover as much of the loan as possible; to recover it at the lowest possible cost; and to maintain an amicable environment with defaulters in order to preserve a positive public image. The five chronological steps of loan recovery begin the moment the loan is disbursed and include (1) efficient administration of the loan to prevent delinquency; (2) managing the first delinquent payment; (3) “amicable treatment” or negotiation and loan work-outs with the borrower; (4) legal action, including foreclosure; and (5) asset management, once foreclosure has been completed. Each stage is managed by a separate team.

Mr. Deletoille explained UCB’s policy formulated to carry out loan recovery action. The key elements of this policy are to be quick; to begin the process amicably while pursuing legal steps; to know well the borrower and communicate with efficiency; to have a clear strategy in case the planned approach does not work; to be professional (firm but courteous); and to adjust policies according to changes in the housing finance market and legal environment. To carry out this policy, UCB has established a “profit center” organization with a specialized data processing capacity to automate loan management and gather useful borrower profiles. The profit center also utilizes a range of professional specialists in areas such as property valuation, asset management, lawyers, and real estate agents to efficiently carry out the recovery process.

With this approach, 94 percent of the loans that go into delinquency are brought back to “normal life” (annually?) _____. The remainder go into litigation, but of those

only 25 percent complete foreclosure. Most litigation is (brokered?) _____ through a private sale. Ultimately, UCB incurs losses in only 30 percent of loans which are legally pursued. Mr. Deletoille concluded that loan recovery can be profitable, and that one UCB loan recovery employee recovers on average about \$200,000 each month.

Mr. Deletoille mentioned that UCB borrowers often buy insurance to cover mortgage payments in cases of illness or unemployment. He noted that most defaults are due to divorce situations.

B) John Forlines

John Forlines of Fannie Mae gave a brief presentation about Fannie Mae's loan recovery procedures, with an emphasis on mechanisms used to prevent foreclosure. Since Fannie Mae buys nearly one of every five mortgage loans made in the U.S., its loan recovery practices are very influential and have helped standardize market practices over the years. Mr. Forlines explained Fannie Mae's motivation for improving loan recovery methods, caused by the rise in loan defaults in the mid-1980's after the severe economic recession in the U.S. Fannie Mae has a number of options available when renegotiating loan terms, including reducing the interest rate on a fixed-rate mortgage, but only to a point no lower than the current market adjustable rate. This can be done for a limited period or longer, depending on the circumstances. Another option is to adjust the term of the loan to make payments more affordable.

Mr. Forlines described a number of mechanisms Fannie Mae uses in the event that loan work-outs fail to recover the loan. These mechanisms include pre-foreclosure voluntary sale, pursued when there is a permanent reduction in income, even if a loss is incurred; deed in lieu, used after other methods are unsuccessful; and "charge-off," when the property value plummets so low that it is cheaper to simply give title free and clear to the borrower. Advances from mortgage insurance companies to keep payments current is another, newer method used to prevent foreclosure. Mr. Forlines also made the point that while Fannie Mae is pursuing all possible means to prevent foreclosure, it pursues legal action at the same time to motivate the borrower to make his best efforts to make the loan current.

V. Topic 3: Other Mechanisms for Managing or Reallocating Risk

A) Douglas Diamond

Douglas Diamond made a presentation on "Allocation of Risk to Third Parties," with a focus on the CEE context. He spoke first about the common role of personal guarantors in CEE housing lending systems which generally serves the purpose of screening out high credit risks before loans are made and is useful in the case of short-term delinquency in which the guarantors put pressure on the borrower to become current with his loan. He noted that heavy reliance on guarantors to actually pay in

case of default would destroy the willingness of people to guarantee loans to other people. Thus, guarantors are not a long-term solution to the problem.

Mortgage insurance is another method used to shift risk and involves a guarantee to repay the loan to the lender in the event of default. However, a mortgage insurance system does not relieve the lender from pursuing all legal recourse prior to collecting on the insurance, thus, the presence of insurance does not resolve the legal difficulties for a lender of enforcing a lien. In addition, mortgage insurance introduces “moral hazard” in to the loan origination and servicing process. Since the losses in case of default are covered by the insurer, there is an incentive to “cheat” the system, and these costs must be borne by the system.

Mr. Diamond explained that in order for government guarantees on mortgage loans to be successful, governments are required to take a tough stance on defaulting borrowers. International experience indicates that this type of guarantee has not been feasible and that guarantee programs around the world have been run into bankruptcy. The social safety net is another more practical way of shifting risks to third parties, according to Mr. Diamond. This method is advantageous because the borrower and lender benefit only if afflicted by some event beyond their control. Some governments offer special assistance with mortgage payments in the event of unemployment, disability, or other such events. In Germany, these payments have been integrated into the broader social net.

B) Achim Dübel

Achim Dübel spoke on the theme of “Causes and Consequences of Residential Mortgage Default in Germany.” The discussion first dealt with the dimension and causes of mortgage default and the difficulties in comparing data across countries. Within Germany today, mortgage default is significantly higher in eastern Germany, and rising, than western Germany. In Germany the general causes of mortgage default include the interest rate cycle (defaults rise when rates decrease); sluggish house prices; unemployment; and social crises. In former East Germany, high unemployment is tempered by government subsidies, and the full impact will be visible only when mortgage loans are more seasoned, in a few years.

Mr. Dübel described underwriting behavior in Germany, which discourages high loan-to-value ratios and encourages savings through the contract savings system. The result has been high equity ratios and low default rates, but also low overall homeownership rates in comparison to most other countries. Germany’s social safety net plays a substantial role in the event of mortgage default. In eastern Germany, regional policy has reduced income insecurity by stabilizing labor markets. In general, generous unemployment insurance and other social benefits, along with a limited housing allowance for homeowners, help prevent mortgage loan default. When

foreclosure does occur, Mr. Dübel explained, Germany has a large private rental housing market with relatively lower rents to absorb former owners, and also offers housing allowances for tenants, debtor consultation services, and a local government support system for the homeless.

Mr. Dübel summarized the foreclosure sequence in Germany, starting with pre-foreclosure process. Interest rate arrears fees charged by banks are quite high in Germany, and serve as an effective deterrent. Banks also may waive pre-payment penalties or renegotiate loan terms to avoid going into foreclosure. The borrower may also voluntarily sell the housing within three months of default. When foreclosure occurs, banks typically sell the property and collect the proceeds. Mortgage liens are separated from all other claims and have the top priority, which puts banks in a very strong position. In the post-foreclosure period, the banks may also continue to collect from the borrower indefinitely in the event that proceeds from forced sale are insufficient to repay the loan, and this is a further deterrent to borrower default.

Mr. Dübel concluded that many aspects of the German system are not transferable to transition countries, such as price and income stability, an extensive social safety net, large alternative rental housing stock, and a complicated foreclosure process. What Mr. Dübel did describe as transferable to CEE is the idea of incentives for contract savings and limited housing allowances.

VI. Future Directions

A) Hungary

Legal Framework. The general consensus from the Hungary breakout sessions was that the legal framework for loan recovery in Hungary is substantially complete. Major legislation providing for execution and enforcement of liens has been approved in the past two years. In addition, procedures have been streamlined and the time line for the foreclosure process has been shortened notably. The most significant problems seem to be the widely divergent interpretations of the legislation from the participants at the colloquium, and that the legal framework itself may contain some conflicting instructions. Examples concerning this lack of clarity include the issue of how to handle eviction. Apparently the Civil Code instructs the occupant to deliver the premises vacant in the event of foreclosure, but the Execution Law does not provide clear or practical guidelines for how this procedure will be carried out if the occupant fails to obey the law.

Another cited example causing some confusion was the requirement to provide alternative housing in the event of foreclosure. According to the Execution Law, the bank has no responsibility to provide alternative housing, but some participants perceived the need or duty for the banks to be socially responsible and provide some

sort of alternative housing. The concept of eviction is still generally regarded as a foreign concept, and many people do not understand the legal process since it has so rarely been pursued.

A recognized problem in the legal area is the low position of mortgage liens in the subordination of debt. Enforcement of a mortgage lien is in the same category as "other claims," after a number of specific claims such as taxes, social security debts, and all other types of public debts. A related issue raised was the lack of clarity in the lien priority system, causing uncertainty when securing a mortgage loan. It was agreed that in order to improve loan recovery, mortgage liens need higher priority in the subordination of debt, and that a clearer, more efficient lien registration system is needed in order to make foreclosure reliable enough to encourage real mortgage lending. High notary fees were also identified as a barrier to foreclosure since loans need to be notarized by the bank in order to take full advantage of the current execution and enforcement provisions.

Preventing Foreclosure. Several tools currently in use or under consideration in Hungary to prevent loans from going into foreclosure were identified during this breakout session. Forebearance of loan payments was cited as a common way to restructure a loan in the case of temporary financial hardship of the borrower. One twist on this concept is in some cases to make forbearance retroactive to the time of default to avoid the need for the borrower to pay unaffordable late fees. Another method used to prevent foreclosure is to lengthen the term of the loan by 2-3 years under the condition that all delinquent payments and late fees be made current. The third major tool used by the banks is to encourage the voluntary sale of property. The group recognized the need for banks to be flexible in this case and to not insist on collection of 100 percent of the loan balance since this process is faster and cheaper to the banks than foreclosure.

Other Mechanisms. The use of third party guarantors was recognized as the principal mechanism for shifting default risk for mortgage loans. Especially in rural areas, this method of minimizing risk has proved very successful.

The feasibility of mortgage insurance in Hungary was discussed, but given the added expenses of such insurance, the willingness or ability of borrowers to pay the premiums was questioned. The group agreed that loan recovery mechanisms could be aided by a third-party institution. Ideas under consideration are the establishment of a risk management and execution company which would buy loans in default for a percentage of their face value, and then attempt to recover them through the foreclosure and execution provisions described in the law. In effect the banks would shift the risk of default, for a price, to the company or agency, which could also be owned by a number of banks involved in mortgage lending. This idea will be analyzed in more detail by some of the participants after the colloquium.

B) Slovakia

Legal Framework. After two days of discussion, the Slovak group agreed that the legal framework for maximizing housing loan recovery in Slovakia has been substantially improved in the last two years. A significant problem seems to be a general lack of knowledge about the legal framework. The bankers present in the Slovak group were surprised to learn of the existence of the Law on Court Executors and Enforcement Activities, passed in December 1995. This law lays out clearer and more timely procedures for foreclosure and enforcement of mortgage liens and provides lenders much stronger mechanisms for recovering housing loans in default. Most importantly, the new law obviates the need for the lender to provide alternative housing to the occupant after eviction. The major challenge appears to lie in the implementation of this new law and dissemination of information about its applications to lenders and the general public.

Other pieces of legislation in Slovakia in the housing finance area include a recently passed act on mortgage bonds in which mortgage bonds are defined, similar to the German system, an act on licensing of mortgage banks, and an act on registration of real property, which will be published in January, 1997.

Other pieces of the legal framework which remain to be completed are the drafting and passage of forced sale (auction) procedures in the event of foreclosure, and a revision of the Civil Code which will provide important changes in the area of rental housing.

Preventing Foreclosure. Banks in Slovakia use the same tools as other banks in the region to prevent foreclosure and manage delinquency, including the use of personal guarantors, garnishment of wages, and loan work-outs. They also face several similar problems in this process. One of the most important is the lack of a reliable property appraisal system, which increases expenses and risks for banks. In addition, there is a lack of information and data collection on loan delinquency and default. In particular, banks generally do not collect information on loan default by cohort but rather as a percentage of the total outstanding loan portfolio. Discussion at the colloquium convinced participants from the banking sector of the value of and need for this type of information.

Finally, the group agreed that there is a need for better information on credit history of prospective borrowers, but that concerns relating to the protection of private information from abuse must also be considered.

Other Mechanisms. The Slovak government has applied direct and indirect instruments to increase the volume and availability of mortgage finance. Direct instruments include the establishment of a National Housing Fund to finance housing

construction and purchase and a construction savings scheme based on the German/Austrian model to channel savings towards housing. Indirect instruments include setting up a structure to establish and encourage mortgage banking and proposals to increase lending through tax reduction policies for borrowers and interest subsidies for mortgage banks.

The group considered the possibility of some form of mortgage insurance as one of the most important conditions for the expansion of the mortgage market, although the expense of such a system was seen as prohibitive. It is more likely that property, life, and other types of insurance will play some role in this area. Legal instruments are also needed to strengthen the social safety net.

In terms of future directions, the group agreed that there will be a continuing need for education and information on a range of related topics such as the preparation and consideration of legal alternatives, possibilities and advantages of different mortgage instruments and tools, possibilities for expanding the mortgage market, and minimizing risk on both the lender and borrower along with consideration of alternative policy tools to accomplish that.

C) Croatia

Legal Framework. As in Hungary, the legal system in Croatia has been updated to provide a solid basis for residential loan recovery, although the new law on execution will take effect only on January 1, 1997. The major gaps in the legal system that need to be addressed in this area are the lack of an accurate and expeditious land registration system and the general slowness in the overloaded court system.

The new law on execution and enforcement of liens provides greater security for housing loans. Streamlined court proceedings should increase the speed and reliability of loan recovery for banks without the need to provide alternative housing. An alternative recovery mechanism is what has been translated as “trustee ownership” or a “fiduciary mortgage.” If the creditor and debtor agree in the loan contract, the ownership of the property is put in trust until the loan is repaid, and in the event of default, the property can be taken over immediately by the creditor without going through the courts.

Preventing Foreclosure. In this area, the Croatian group identified common causes of housing loan default, including illness, divorce, death, disability, and unemployment, and the different nature of these causes. The group also recognized the underdeveloped credit culture in Croatia, partly due to expectations of inflation as a result of past experience. There also seemed to be genuine perception that a significant number of loan defaults are caused by individuals being overburdened with credit. This was attributed to both a lack of good information and underwriting

standards at the banks and the ability of certain people to obtain loans without regard to normal underwriting standards through personal influence.

The legal restrictions that debt cannot exceed 1/3 of income; garnishment of wages cannot exceed 1/3 of income (*ask Ognjen; was this seen as a constraint on the banks or good discipline?*) Conflicts with 50% PTI ratio...

Banks have experienced great difficulty recovering loans from persons migrating or leaving the country due to the war in Croatia. Although this problem should not be considered a long-term issue for banks, it may have contributed to the deterioration of the credit culture in Croatia. In addition, banks are constrained by so-called “moral issues” whereby pre-foreclosure sales to third parties are difficult particularly in rural communities since there is reluctance to purchase the property of a defaulting borrower known to the local community. This means the bank usually takes possession of the property and then sells it, a more costly and time-consuming process for the bank.

Other mechanisms. As in the other participant countries, the Croatian group agreed that the use of personal guarantors is the most common method of default prevention and loan recovery, and it has proven quite efficient and effective. The group reached a consensus that in order to encourage more and cheaper lending, the role of the state in this area must be more transparent and clearly defined. Recommendations included formulation of a clear, step by step housing policy, including the development of conditions for cheaper housing construction costs and stabilizing the financial system.

The group recognized the difficulty for the banks to initiate new policies or loan programs unless the economic and political situation in the country is stable and healthy. The general feeling of insecurity in the banking system is caused by recent memories of hyper-inflation and currency and deposit instabilities resulting from the war and the previous socialist economic system.

The lack of a mortgage insurance instrument or institution was also cited as an area for future consideration, although the government has taken steps recently to establish a deposit insurance system similar to the U.S. A lack of information or central data base regarding the credit history of potential borrowers also increases the lending risks for banks, and establishment of such a credit bureau or “black list” would contribute to safer lending practices.

VII. Conclusions

Conclusions based on the colloquium presentations and plenary and country break-out discussions were offered by Doug Diamond, Carol Rabenhorst, and Ivan Tosics.

Mr. Diamond began by emphasizing the perfect marriage between housing as an investment and the modern financial system. Since the longevity of a typical home outlasts the buyer, it makes sense that the dwelling be financed over a long period of time, instead of forcing the buyer to wait a long time to accrue enough funds to pay cash. In developed countries, housing finance systems have been converging, especially over the last 15 years. There is increased competition among financial institutions and an integration of deposit-based systems with mortgage bond-based systems. There has also been an increase in risk management activities, especially in such areas as interest rates, credit, and pre-payment policies.

However, there has been less convergence in housing loan recovery across countries. This holds true for the three focus countries of the colloquium, despite the historical antecedents from the Austro-Hungarian model. Mr. Diamond concluded that developing a reliable system for housing loan recovery necessitates a large amount of communication and cooperation among all players in the system, and that the focus should now be placed on developing a system which balances the needs of the banks, borrowers, courts, and politicians.

Carol Rabenhorst stated her conclusions next, starting with an observation that while much of the legal framework required for loan recovery is now in place, banks are still not making "mortgage" loans yet; that is, loans based on the borrower's promise to pay, secured solely by the property purchased. Cultural and historical factors play an important role in this. There are also a number of secondary legal issues that remain to be resolved such as the administration and implementation of the mortgage system, priority of payment after execution, and other areas such as mortgage insurance, credit bureaus, etc., which can be considered still part of the legal system. It will take a great leap of faith to make true mortgage loans based on the security of the property at this time; yet that is what is needed most.

Rabenhorst concluded that overall, significant progress has been made to fundamentally restructure the housing finance and broader financial systems in the participating countries, especially considering the short time frame of only five to six years from which major reforms have begun. Also, Rabenhorst stated, colloquium participants seem to have reached some common recognition of problems, and she is optimistic about continued progress in this area.

Ivan Tosics summarized the special problems to be considered in transition countries in relation to the development of a loan recovery system. Since the CEE region is still in transition, there remains a significant public sector demand for financial resources, and banks seem to prefer this low-risk, high yield environment to housing finance. Second, expectations for housing in the region have been historically high, but based on an untenable system initiated under socialism. In addition, the extent of the black market economy makes it difficult for banks and policy makers to assess real

incomes and structure policies accordingly.

Mr. Tosics continued that with the current environment of mistrust in government institutions across the region, it is unrealistic to expect the establishment of credit bureaus as they exist in France or the U.S. because a premium is now placed on privacy of information. In addition, the unusually high home-ownership rate in the region (in particular in Hungary) complicates the loan recovery process because probably more than half of current home owners do not have sufficient income to qualify for a bank loan under market terms. However, underwriting cannot be more strict than it is today, where loans are secured by the borrower and several guarantors who pledge everything they own as collateral for a small loan. On the other hand, Mr. Tosics explained, foreclosure in Hungary will never be as efficient as in the U.S. due to cultural and historical reasons.

Mr. Tosics concluded with some thoughts on future directions. First, banks must become more interested in housing finance. This will happen in tandem with financial sector reform, and is already occurring in some countries such as Poland. Second, some creative solutions must be found for low income owner occupants who possess valuable real assets but little ability to get financing for renovation and repairs. Finally, Mr. Tosics stated that the legal framework for loan recovery is more or less in place, but more work needs to be done on implementation of these new laws. The colloquium provided a valuable forum to discuss these issues and create momentum.

VIII. USAID Recommendations

The following recommendations can be made with regard to future technical assistance activities in the three participant countries of Croatia, Hungary, and Slovakia.

- ! The colloquium demonstrated a clear need for more communication between legal and banking professionals on the untested legal framework for loan recovery and the acceleration of its practical application in all three participant countries. Exchanges could take place in the form of short seminars in each country designed to seek consensus on legal interpretations of recent legislation in each country, and dissemination of implementation experience as it develops.
- ! Technical assistance is still needed to address secondary legal issues and recovery procedures. In particular, Slovakia needs a law on foreclosure auction procedures, and clarification or restructuring of priority of payments is needed in all three countries.
- ! Technical assistance could be delivered in the collection and analysis of data on loan default and delinquency and their causes in selected CEE countries, or in

specific banks. The colloquium demonstrated a significant information gap in this area across the region. Assistance could be delivered to individual banks to develop their capacity to analyze loan default by cohort in order to better identify and manage delinquency and default risks.

- ! The prospect of seminars or more detailed analyses regarding the topic of government or third party interventions in strengthening loan recovery was welcomed by all the participant countries. The Hungarian group was particularly interested in exploring the idea of establishing a company or bank to purchase bad housing loans from other banks at a discount. All country groups were interested in exploring the establishment of credit bureaus or databases for use in evaluating potential borrowers.

VIII. Annexes/conference materials

- (A) Colloquium Participant List
- (B) Colloquium Agenda
- © "Maximizing Housing Loan Recovery: Lessons for Central and Eastern Europe" [paper] (*Banks, Diamond, O'Leary*)
- (D) "An Overview of the Loan Recovery Colloquium" [remarks] (*Diamond*)
- (E) "Establishing the Legal Basis for Housing Mortgage Loan Recovery" [remarks and overheads] (*Rabenhorst*)
- (F) "Maximizing Housing Loan Recovery - Alternatives to Foreclosure and Eviction" [overheads] (*Deletoille*)
- (G) "Causes and Consequences of Residential Mortgage Default in Germany" [paper and overheads] (*Dübel*)
- (H) "Allocation of Risk to Third Parties" [remarks] (*Diamond*)
- (I) "Mortgage Banking - New Type of Activity in the Slovak Republic" [paper] (*Mučková*)

**PARTICIPANT LIST - CEE LOAN RECOVERY COLLOQUIUM
BUDAPEST, DECEMBER 16-17, 1996**

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**CEE HOUSING LOAN RECOVERY COLLOQUIUM
DECEMBER 16-17, 1996
BUDAPEST, HUNGARY**

**Tentative Agenda
(Internal-Do Not Distribute)**

Sunday, December 15

Participants arrive in Budapest

7:00 Reception and Registration
Participants will be told at check-in where reception will take place

Monday, December 16

8:15-9:00 Registration

9:00 Welcome (*Ágnes Balázs, Hungarian Ministry of Finance and USAID/Budapest (Larry Birch, Senior Housing Advisor)*)

9:15 Colloquium Overview (Doug Diamond)

TOPIC 1: The Legal Basis for Residential Mortgage Loan Recovery. Based on international and regional experience, speakers on this topic will discuss means of establishing the legal basis for mortgage loan recovery (Civil Code, Mortgage Law, law on court procedures, etc.) and overview the necessary provisions that should be in the legal framework for successful loan recovery.

9:30-10:15 **Speaker 1 (Carol Rabenhorst, Senior Legal Advisor, The Urban Institute):**
P “Establishing the Legal Basis for Housing Loan Recovery”
The speaker will outline the essential components of the legal basis for housing loan recovery, including foreclosure and execution procedures. Country examples from the U.S. and Central and Eastern Europe will be discussed.

Presentation: 30 minutes; Q&A: 15 minutes

10:15-10:45 **Speaker 2 (Dr. Olga Hildebrandné, Director, Department of Justice Administration and Codification, Hungarian Ministry of Justice)**
P “Housing Loan Recovery in Hungary” The speaker will discuss the development and current legal basis for mortgage loan recovery in Hungary.

Presentation: 20 minutes; Q&A: 10 minutes

10:45-11:00

Coffee Break

11:00-11:45

Panel of Experts (5-10 minutes each)

Representatives from several CEE countries will respond to the main speakers' presentations. Representatives from:

P Slovakia: Sergei Kohut, President, Supreme Court (to confirm)

P Croatia: Zoran Barac or Zeljko Lourinčević, Parliament (to confirm)

P Poland: Barbara Gilicińska, PAM Bank (to confirm)

P Hungary: János Pesta, Ministry of Justice (to confirm)

11:45-12:45

Country Breakouts: Each of the three participant countries will break into groups (Hungary, Croatia, Slovakia) for one hour for a structured discussion of Topic 1 in more detail. Moderators will facilitate discussion to prepare a concrete list of key legal issues and recommended improvements in each participant country. Group Leaders for each session will be responsible for summarizing group discussion and presenting the results back to the plenary session.

Breakout moderators for all three sessions are suggested as follows:

Hungary: Erika Farkas (Topic1) and Ivan Tosics (Topics 2&3) MRI

Slovakia: Jaroslava Zapletalová, Ib

Croatia: Ognjen Čaldarović, University of Zagreb (Kuzmić if desired)

Spokespeople for Topic 1 are suggested as follows:

Hungary: Miklos Krejniker, Chamber of Hungarian Court of Executors

Slovakia: Alžbeta Štangová, Association of Banks (to confirm)

Croatia: Ana Penavin, Slavenska Banka (to confirm)

1:00-2:00

Lunch

TOPIC 2: Maximizing Housing Loan Recovery—Alternatives

to Foreclosure and Eviction: Speakers on this topic will discuss alternative approaches to loan recovery, other than foreclosure, by working with borrowers to restructure loans, forbearance, third party guarantors, and other strategies.

2:00-2:45

Speaker 1: (Denis Deletoille, Director, Housing Loan Recovery Division, Union de Crédit pour le Bâtiment, France)

P “Housing Loan Recovery in the France” In the difficult environment for foreclosure in France, the speaker will discuss the application of several innovative approaches used to maximize housing loan recovery.

Presentation: 30 minutes; Q&A: 15 minutes

- 2:45-3:00 **Speaker 2: (Slovakia: Jarmila Jurkovičová, Slovenska Sporite a)**
P “**Housing Loan Recovery in Slovakia**” The speaker will briefly present various recourses and remedies used in Slovakia, such as loan work-outs and renegotiations, to maximize loan recovery.
- 3:00-3:15 **Speaker 3: (U.S.A.: John Forlines, Fannie Mae)**
P “**Loan Recovery Tools and Practices**” The speaker will briefly present loan recovery tools and practices currently used in the U.S., with a commentary on appropriateness of these tools to the CEE context.

Q&A: As time allows

3:15-3:30 Coffee Break

- 3:30-4:15 **Panel of Experts (5-10 minutes):**
P Hungary: Dániel Béza, OTP
P Czech Republic: Václav Jabírek, Komerční Bank (to confirm)
P Croatia: Mladen Šorić, Zagrebačka Bank (to confirm)
P Poland: Irena Stocka, PBK (to confirm)

4:15-5:15 **Country Breakouts:** Each of the three participant countries will break into groups (Hungary, Croatia, Slovakia) for one hour for a structured discussion of Topic 2 in more detail. Moderators will facilitate discussion to prepare a concrete list of key banking issues and recommendations for improvements in each participant country.

Spokespeople for Topic 2 are suggested as follows:

Hungary: Péter Bíró, OTP
Slovakia: Eduard Hyranek, Association of Banks (to confirm)
Croatia: Vinka Pfeifer, Zagrebačka Banka (to confirm)

Tuesday, December 17

TOPIC 3: Other Mechanisms for Managing or Reallocating Risk. Speakers on this topic will discuss alternative arrangements for managing credit risk, other than normal loan recovery. Methods for reallocating risk to third parties including private mortgage insurance, unemployment related payments and housing allowance will be examined.

- 9:00-9:45 **Speaker 1 (Doug Diamond, International Housing Finance Specialist):**
P “**Managing and Allocating Risk: An International Perspective**” The speaker will overview the issue of managing and allocating credit risk and discuss a range of mechanisms used in the U.S. and other countries.

Presentation: 30 minutes; Q&A: 15 minutes

9:45-10:30

Speaker 2 (Achim Dübel, Empirica (Germany))

P “Credit Risk Management in the Former East Germany” The speaker will discuss how lenders in the former East Germany have readjusted their approaches to risk management (approaches very similar to other CEE countries) since reunification to comply with West German laws and practices.

Presentation: 30 minutes; Q&A: 15 minutes

10:30-10:45

Coffee Break

10:45-11:30

Panel of Experts (5-10 minutes)

P Hungary: Vera Tömöri, K&H Bank

P Slovakia: Viktoria Mučková, Institute of Monetary and Financial Studies (to confirm)

P Croatia: Petar Mandić, Bank for Reconstruction and Development (to confirm)

P France: Denis Delatoille, Union de Crédit pour le Bâtiment

11:30-1:00

Country Breakouts: Each of the three participant countries will break into groups (Hungary, Croatia, Slovakia) for one hour for a structured discussion of Topic 3 in more detail. Moderators will facilitate discussion to prepare a concrete list of key legal issues and recommended improvements in each participant country.

Spokespeople for Topic 3 are suggested as follows:

Hungary: György Telekes, Ministry of Finance (to confirm)

Slovakia: Pavel Giller, Ministry of Construction and Public Works (to confirm)

Croatia: Tatjana Kovač, Ministry of Finance (to confirm)

Groups will prepare presentations for “Future Directions” session.

1:00-2:00

Lunch

2:00-3:30

FUTURE DIRECTIONS: During the afternoon the spokespeople from Croatia, Hungary and Slovakia will report back to the plenary session on the results of the three break-out group discussions. The presentation will attempt to synthesize discussions and identify the key issues in each country and the priorities for future government and banking sector actions. Participants from other countries will be allowed time to comment on the presentations in front of the plenary group.

3:30-3:45

Coffee Break

3:45-4:45

CONCLUSIONS: The colloquium organizers will sum up the events of the colloquium discussions and draw conclusions and consensus on next steps for the participant countries.

**MAXIMIZING HOUSING LOAN RECOVERY: LESSONS FOR
CENTRAL AND EASTERN EUROPE**

The Urban Institute

Report prepared for
CEE Housing Loan Recovery Colloquium
December 16-17, 1996
Budapest, Hungary

MAXIMIZING HOUSING LOAN RECOVERY: LESSONS FOR CENTRAL AND EASTERN EUROPE

I. Introduction

The countries of Central and Eastern Europe (CEE) need viable housing finance systems that operate on market principles and provide adequate protections to lenders. It is clear that the housing finance systems operational during the pre-transition period are not sustainable, at least in part because rates of loan recovery are not high enough to maintain attractive profitability for housing lenders. High rates of default with few practical means of recovery can mean significant losses for lenders, deterring lending for housing and possibly jeopardizing even the larger financial systems within which lenders operate. Implementing a broader range of solutions to maximize loan recovery will encourage banks in CEE to break free from their very cautious lending practices (such as requiring large downpayments and multiple guarantors) that currently limit the market, subsequently making housing credit accessible to more households.

The goal of this paper is to provide a practical discussion of a number of mechanisms typically used to maximize loan recovery. Section II provides a brief background on housing finance in the pre-transition period and some characteristics of current housing finance systems in the region. Section III.A presents strategies for risk management and loan default prevention such as risk allocation between borrower, lender, and third parties, and developing or changing institutional practices to allow for renegotiations and workouts in the event of borrower default. Section III.B presents a number of loan recovery mechanisms as alternatives to foreclosure ("work-outs") such as forbearance and renegotiation of loan terms, voluntary sale of the property, and deed in lieu of foreclosure. Finally, Section III.C discusses methods of improving existing foreclosure and eviction laws and practices. A solid legal basis for foreclosure and eviction is necessary to encourage compliance with less stringent methods and ultimately to ensure loan recovery for lenders in the event that interim measures are unsuccessful.

II. Background

Before 1989 housing loan recovery in CEE countries was based on a number of economic and social assumptions unique to the socialist period. The macroeconomic situation for the most part was one of stability, including implicit employment guarantees to citizens working in state-owned or controlled enterprises (except in the former Yugoslavia). This signified a reliable stream of income for borrowers of long-term housing loans unmatched in most market economies. Financial terms for housing loans were remarkably soft, including 30 year or longer loan terms and interest rates fixed at low levels unseen in other economies and made possible by state subsidies. The terms were not based on bank profitability or viability. Banks possessed an array of loan recovery tools particular to the socialist economic system, the most significant being the easy access to the garnishment of wages for employees working in public enterprises. Given the availability of such simple mechanisms for loan recovery,

security of real property as collateral for loans existed mainly on paper and rarely needed to be relied on.

This situation is somewhat analogous to Western Europe in the 1960s and 1970s, when employment levels were stable and personal relationships to the economy were more secure than they are today. In the more recent past, the economic situation in Western Europe has resulted in more personal dislocation and change, with a concurrent increase in housing loan delinquencies and defaults.

One characteristic of the transition period with respect to housing finance is a growing demand for rehabilitation and purchase of existing housing. The number of transactions in the housing finance market, particularly with the ongoing or nearly complete process of housing privatization across the region generating substantial real estate sales activity, has increased substantially. On the other hand, more uncertainty now exists with respect to employment and the concurrent ability to repay housing loans. This implies the increasing importance of the security of collateral in housing finance systems.

An important long-term trend in the development of housing finance and loan recovery is the evolution of what has been termed the “credit culture;” in other words, how credit is treated from a social and cultural point of view. The credit culture is important because, in most cases, loan repayment is a matter of economic choice. Even if a borrower is faced with a severe financial hardship, for example unemployment, he usually has some options. Such options may include selling his pledged property to repay the loan and adjusting to a more affordable situation, such as renting a smaller flat or moving in with relatives. Alternatively, the borrower may simply choose not to repay the loan and face the consequences, which may vary from country to country.

A strong credit culture is a major ingredient to the success of loan recovery and the health of the financial system. When the borrower discovers that default does not result in foreclosure on the property pledged, or that the legal system protects the borrower from any major consequences, the credit culture deteriorates. An example is the recent case of loan repayment rates in Hungary. When the terms of the pre-transition housing loan portfolio (with loans fixed at three percent and 30 year terms) were changed to market rates (often at 50 percent forgiveness), they were subsequently guaranteed by the government since it was believed that market rates were not affordable or fair to most borrowers used to the old terms. The government guarantee signified to the borrowers and lenders that loan delinquency or defaults would not be penalized and that the cost would be covered by the government. The result has been that delinquency and default rates have increased despite the relatively small burden of these loans.

A key difference between the housing finance system in CEE and those in Western Europe and the U.S. is how credit risk is viewed. In developed market-based systems, the major determinant of credit risk is the buyer's equity in the home. Thirty to forty percent equity, in the current context, is considered essentially risk-free by banks making loans. In CEE, this is the starting point for home loan downpayments; after that is made, an array of tools are

applied, in addition to the pledge of property, to reduce the credit risk. Even then, recovery is by no means ensured and delinquency and default rates are significantly higher than in Western Europe or the U.S.

III. LOAN RECOVERY MECHANISMS

For a number of reasons it is difficult to quantify housing loan defaults in CEE. Preliminary research conducted for this background paper confirms this assertion. Banks are only now developing transparent methods of tracking and reporting defaults and using accounting methods that accurately calculate the number of volume and unpaid loans. Typically, loan default and delinquency information is tracked for a bank's entire portfolio, thus data reflect only general numbers for the entire stock of loans.

Data from the State Savings Bank in Hungary indicates a loan delinquency rate, defined as loans delinquent more than 30 days, of approximately 19 percent. Croatia's second largest housing lender estimates loan delinquency rates ranging from 8 to 20 percent depending on the month of the year. Comparable figures for Slovakia were unavailable but are likely to be in a similar range. Loan defaults in Hungary are estimated at 6 percent of the total housing loan stock in the most recent data available. Default rates in Slovakia were slightly less at 5 percent in 1995, but they have risen more than 10 percent over the 1996 levels in the first nine months of 1996. In Croatia, the two largest housing lenders estimate loan default rates at between 1 and 1½ percent, suggesting the existence of more effective alternatives used to prevent loan default and, subsequently, foreclosure. In general, delinquency and default rates are rising and due to economic difficulties and weak recovery enforcement to date, there appears to be no obvious reason for them to fall.

Accurately tracking loan defaults is half the battle in managing credit risk. Defaults should always be monitored by cohorts. In other words, defaults on just those loans made in 1993 (for example) should be examined, rather than the whole portfolio. As this block of loans ages and the borrowers are impacted by various events, this response should be watched and lenders should respond. Looking at the whole portfolio or just the amount of overdue payments can be very misleading because it distorts default rates into an average. An increase in defaults or delinquencies, undefined by cohorts, will not tell a bank what part of its portfolio is most at risk nor when to expect a pattern of problems. For instance, a 5 percent default rate for a 1993 cohort of loans would suggest to a bank that its 1995 loan cohort will reach 5 percent default by the time it is three years old, even if its default rate is currently much lower (since the newer loans are less likely to default). The big problem to be attended to is those loans which lapse into severe delinquency, from which recovery will be very difficult or impossible.

Another important consideration in managing credit risk is designing a system that prevents default and provides lenders an array of loan recovery options in the event default prevention is unsuccessful. The elements of such a system—effective loan default prevention and risk management strategies, loan recovery alternatives to foreclosure, and reliable foreclosure and eviction laws and procedures—are discussed below.

A. Risk Management

A well-functioning housing lending system needs reliable loan recovery mechanisms in cases of default, as well as a number of methods of preventing default and managing risk.

These methods include careful underwriting of the loan and quick response to borrower delinquency, setting loan terms to encourage borrowing only by the most secure borrowers, and allocating risk to third parties.

Careful Underwriting

One of the most important tools to prevent borrower default is for banks to institute good underwriting practices, i.e. bank procedures for assessing the borrower's creditworthiness before the loan is made.

Assessing a borrower's creditworthiness involves consideration of a number of factors. A bank will reap the rewards of time spent up front considering these factors by lending to borrowers who will ultimately display good payment habits. Factors to consider in deciding whether a borrower is a good credit risk include the borrower's income and assets, credit history, and employment history. The bank should also ensure that the borrower has good title to the property used as collateral by requiring a title search of the property and if possible obtaining title insurance. Finally, although not directly related to the borrower's personal credit risk, the bank should ensure that the purchase price for the property is an accurate assessment of the property's value and that the value is not likely to decrease over time. An inspection and appraisal should be conducted of the property to determine its market value. Also, the bank should research the general economic health of the region where the property is located to determine any trends that may lead to the property decreasing in value over time.

Lending Terms

Another element in managing credit risk is to impose lending conditions and draft terms into the loan documents that encourage borrowers to pay their debts. Low loan to value (LTV) ratios, high interest rates, loan acceleration clauses and penalty provisions are examples of these types of conditions. Banks should be sensitive, however, that the more conservative these lending terms are, the smaller the market for potential borrowers that qualify for housing loans will be.

By requiring large downpayments banks can insure that borrowers have invested a sufficient amount of their own funds to encourage them not to default on their loans and to provide the lender with assurance that the collateral protects the loan. Imposing low loan to value ratios for housing loans is one approach typically used by banks throughout CEE. In Poland, LTVs are in the 60 to 70 percent range. In Hungary, LTVs are rarely higher than 30 percent. In practice, these low LTVs do not matter if the lender does not have the ability and will to foreclose and sell the property.

Two other alternatives that encourage borrowers to stay current with their loan payments are loan acceleration and penalty clauses in the loan documents. Loan acceleration allows the lender to demand full payment of the outstanding loan balance if the borrower is delinquent on a payment. Penalty clauses may be charged as flat or percentage fees charged on the amount

in delinquency and usually include provisions requiring the borrower pay all court and execution fees if the lender pursues a foreclosure action.

Allocation of Risk to Third Parties

One approach to managing credit risk is to shift the risk elsewhere, i.e., to third parties other than the borrower and lender. This can be advantageous, but only if the benefits outweigh the cost.

In theory, many CEE lenders already shift their risks to third party guarantors of the housing loan. These other private individuals promise to make repayment if the original debtor defaults. In order to make this a credible alternative, the guarantors must have a high level of income and a low level of debt. In some cases, lenders will pursue collection from third party guarantors if the borrower defaults. This practice also has the effect of not actually shifting the credit losses to the guarantors, but screening out those with higher credit risks before they can even borrow. Only individuals with relatively substantial financial resources can muster two or three other friends with substantial resources to act as guarantors. The guarantor requirement reduces the ability of many households to access credit and shrinks the potential market for lending. However, it probably is useful for generating the special attention to a short-term delinquency to prevent it from turning into a long-term default.

Of even more comfort to a lender is the presence of some kind of mortgage insurance or government guarantee that indemnifies the lender in case of loss. Such insurance can be based on two different types of coverage: (1) the option to transfer ownership of the property to the insurer in return for full payment on the loan, or (2) reimbursement for any (or a part) of unrecovered losses after foreclosure and disposition of the property. It is important to note that mortgage insurance is usually of the latter type, and therefore does not relieve the lender of the burden of pursuing all legal recourse prior to collecting on the insurance. Thus, the presence of mortgage insurance will normally not reduce the difficulties posed by legal and administrative structures poorly designed to support foreclosure, nor the adverse publicity accompanying such actions.

In fact, mortgage insurance is usually only applicable to exposure beyond some maximum loan-to-value ratio. The premise is that risk really arises only from the likelihood of the sale of the property not covering the loan, making the assumption that execution of the lien on the property is relatively straightforward. Mortgage insurance is not normally based simply on the likelihood that the borrower will default.

Despite this extra cost, mortgage insurance is commonly used in the U.S. and the U.K. Why? The basic advantage of mortgage insurance is that it spreads risks over a number of lenders and regions. This is especially important when a country has many small lenders operating in segmented regions. This is not important when all lenders are relatively large and operating over all regions in the country. In these situations, it is not clear that the gains from spreading risk exceed the costs of increased moral hazard.

There is one other possible reason why lenders may be willing to pay more than the expected amount of loss to get someone else to bear the risks. That reason is to avoid bad publicity from harsh loan recovery activities. If the insurance company is in a better position to bear that bad publicity, then there may be room for making such insurance viable.

There is another way of shifting risks to third parties. This refers to the risks of the underlying causes of defaults, usually physical disability, unemployment, or family crisis. It is possible to require life or disability insurance against physical illness. The government usually offers some protection, although limited, against unemployment. Some governments offer special assistance with mortgage payments. In addition, private insurers in Western Europe also offer mortgage payment coverage in cases of involuntary unemployment. Marital or other family crises are more difficult to indemnify against.

Delinquency Management

Even in circumstances where a bank has performed sufficient analysis to determine a borrower a good credit risk, circumstances may arise that prevent a borrower from paying a loan on time. To minimize the cost to the bank and to prevent borrowers from developing poor payment habits, banks should have reliable systems for tracking delinquencies and respond promptly and consistently to borrower default.

Most current lenders in CEE have competent systems in this regard, but there is usually room for improvement. Especially if a lender wants to avoid reliance on foreclosure, intensive management of delinquencies is needed to prevent the amount overdue growing to such a large sum that working out an arrangement with the borrower to repay the sum becomes impossible.

It is important that banks respond within the first month of borrower delinquency. One possible collection strategy is to mail the borrower notice of late payment followed up by a phone call if the borrower does not respond to the notice by paying the amount due. The bank may also charge fees for late payments as an incentive to borrowers to pay on time. If the borrower continues to be delinquent for an unacceptable period of time or chronically makes late payments a bank representative may meet in person with the borrower or offer the borrower counseling in order to determine the reason for the borrower's poor payment habits. One solution may be for the borrower's mortgage payment to be deducted directly from the borrower's paycheck or bank account and sent to the bank. If it is clear that the borrower is unable or unwilling to make timely payments, the bank should pursue the option of foreclosure and eviction or some of the alternatives to foreclosure discussed below.

B. Alternatives to Foreclosure and Eviction

For legal, social or financial reasons lenders may be reluctant to pursue the remedy of foreclosure. In some countries the legal basis may be nonexistent or incomplete. In other countries, lenders may not exercise their legal right to foreclosure and eviction because it is socially unacceptable to displace families. Finally, even where an adequate legal basis exists,

lenders may consider the process too lengthy or expensive compared to the loan recovery they are likely to achieve through other methods. For all of these reasons there are a number of alternatives to foreclosure that are currently used or could be used by lenders in CEE.

Forbearance and Renegotiation of Loan Terms

Forbearance and renegotiation of loans terms may be considered when the borrower is experiencing temporary financial hardship because of unemployment, illness, death of an income-earning spouse, marital problems, or similar reasons. If it is clear that the borrower's financial position is fundamentally and permanently changed and even renegotiating the loan terms will not be sufficient for the borrower to bring his debt current, then the lender should probably not consider these alternatives.

Forbearance is an agreement between the borrower and lender to suspend or reduce borrower payments for a temporary period. The agreement should be in writing. Forbearance does not waive the borrower's payments. When the period of forbearance is over, the borrower must repay the debt forborne, usually by increasing regular monthly payments until the forborne amount is repaid.

Renegotiating loan terms may involve lowering the interest rate or monthly payment, extending the period of repayment, or modifying the mortgage instrument, for example, by changing the interest rate from fixed to variable. Lenders may require that the borrower first make good on all delinquent payments before agreeing to make modifications to the loan terms. Alternatively, the lender may allow the borrower to capitalize delinquent payments into the total outstanding loan balance.

There are two legal points that must be considered in renegotiating loan terms: the impact on junior lienholders and the borrower's right of redemption. Depending upon the relevant law, parties may need to receive permission from junior lienholders before renegotiating loan terms. This is because renegotiating the loan terms may increase the total debt eventually repaid or spread the debt payments out over a longer period than originally scheduled, thus putting the junior lienholders in a less advantageous position than they originally occupied when their lien attached. The lender will want the junior lienholders to agree that the renegotiated loan remains a lien in a superior position to other liens. Second, if the relevant law contains a right of redemption and the lender requires the borrower to make payments current before renegotiating the loan, then the lender will not be able to unilaterally change the loan terms without the borrower's consent. Exercising the right of redemption by paying all outstanding debt gives the borrower the same contract rights he enjoyed before violating the contract by defaulting.

The advantage to the lender of forbearance and renegotiation is they are much less costly alternatives than foreclosure or the other remedies discussed in this section. Particularly if the borrower has a good payment history and is only experiencing a temporary hardship, it is likely that the borrower will resume timely payments in the future and the lender suffers a

negligible loss. The primary advantage to the borrower is that he is able to keep his home and the bank will cooperate with him to get through a temporary financial crisis.

Voluntary Sale of Property and Assumption of the Mortgage

Voluntary sale of the property may be considered an option after other attempts at renegotiating the loan terms or allowing the borrower a period of forbearance have failed, or the lender for other reasons determines the borrower is unlikely to pay the debt owed. The property owner is responsible for undertaking all necessary measures and paying for costs associated with marketing and selling the property. Sales proceeds are turned over to the lender to satisfy the outstanding debt. The seller retains proceeds in excess of the debt. If the sales proceeds are less than the outstanding debt, the lender may accept this amount or, if legally permissible, pursue a deficiency judgment against the owner for the outstanding balance. To avoid a drawn out process of sale of the property, the lender may consider pursuing foreclosure action simultaneously with the borrower's attempts to sell the property in the event the borrower is unable or fails to make a good faith attempt to sell the property.

Assumption of a mortgage may be distinguished from sale of the property because it involves transfer of the mortgage to another party without actual sale of the property. The party assuming the mortgage simply agrees to stand in the place of the original borrower vis-a-vis his contract relationship to the lender. Although an assumption produces the same result as an voluntary sale of the property—the borrower loses his home—the process may be less costly and quicker for all parties involved.

Deed in Lieu of Foreclosure

A deed in lieu of foreclosure occurs when a borrower transfers property title to the lender to satisfy the outstanding debt. One advantage to both borrower and lender is that this process is quicker and less expensive than foreclosure. Lenders may be particularly interested in this solution if it is unlikely there will be interested bidders at auction and the lender will be forced to purchase the property in any event. The primary disadvantage to the lender is that a deed in lieu of foreclosure generally cannot be used when there are junior lienholders, unless those liens are satisfied. Another disadvantage to the lender is that it will be forced to maintain and market the property in preparation for sale if it does not wish, or the law does not allow the bank, to retain the property as a bank asset. Borrowers may prefer the deed in lieu option if they have little equity in the property and transferring the title frees them from all financial obligations. The opposite is true for borrowers who have substantial equity in the property and the market value of the transferred property is higher than the outstanding debt.

Garnishing Wages

Garnishing wages is a long established mechanism for loan recovery used throughout CEE. Garnishing wages may not offer lenders the same easy solution to loan recovery as in the past as real wages remain relatively low, unemployment rates high, and employment stability is no longer ensured as it was during the pre-transition period. In addition, a court

procedure may be required before a lender may garnish a borrower's wages. However, it may be appropriate in some circumstances where the borrower and lender negotiate an arrangement that the mortgage payments are deducted directly from a borrower's paycheck, bank account, or other source of funds on a monthly basis to make regular mortgage payments. However, many borrowers may be reluctant to relinquish control over their finances in this way.

C. Foreclosure and Eviction

Residential lending is generally considered low risk because of the ability to place a lien on immovable property. This allows the possibility of seizing and selling the property, usually the residence, used as collateral for the loan for at least the value of the outstanding loan. In order for this remedy to be effective, there are a number of legal provisions that should be in place, and a number of related provisions that may be included in the relevant legal framework to provide relative advantages or protections to borrowers and lenders.

Clear Registration Procedures

It is essential to have clear procedures for registration of title and mortgage liens. Mandatory registration promotes use of the public record as a reliable source of information on the status of encumbrances on the property and allows lenders to assess whether making a loan is overly risky because there are too many liens on the property or there are problematic title issues. Rules for determining lien priority are necessary for lienholders to know where they stand in line to collect in the event the borrower defaults on a debt and a lienholder seeks to perfect a lien by foreclosing and selling the property.

The U.S. has a complex real property registration system. As a general principle, the system is designed to promote transparency in the public record and to protect those that register in a timely method while offering lesser protections to those that do not. Registration of real property rights and encumbrances is required if the holders of those rights want them to be legally protected. Lien priorities often follow a "first in time, first in right" rule, although the law may give some liens higher priority (debts owed to the government, for example) regardless of when they were registered.

Real Property as Collateral

One of the most basic provisions necessary for foreclosure is the right to use the property that is the subject of the loan as collateral. For most borrowers their home is their only asset valuable enough to serve as collateral for the full amount of the outstanding housing loan. In most market economies it is standard lending practice for the property which is the subject of the mortgage loan to be used as collateral for the loan. If the sale proceeds are insufficient to cover the balance of the outstanding loan after sale of the seized property, lenders may be allowed to pursue a deficiency judgment against the borrower and seize other assets of the borrower to satisfy the remaining balance. In Hungary, until recently the debtor's real property

could be seized and sold only after personal property.¹ However, 1996 changes to the Civil Code introduced the concept of an “independent mortgage” which permits the parties to agree in the loan contract that only the real property securing the mortgage is subject to foreclosure, without access to the borrower’s other assets.²

Clear and Efficient Execution Procedures

The law should clearly describe the process required to obtain a right to foreclosure and the process for executing the foreclosure judgment. Procedures to be described include who has the authority to execute fees that may be charged and the priority of payments from the proceeds of execution.

There are at least three possible methods of foreclosure: strict foreclosure, judicial foreclosure, and non-judicial foreclosure. Strict foreclosure allows the mortgagee, the lender, to be decreed full owner of the property without sale of the premises. The advantage to the lender is that the process is quick and inexpensive. The disadvantage is that strict foreclosure often, although not always, cuts off the lender’s right to pursue a deficiency judgment in the event the value of the property is less than the outstanding debt. The prime disadvantage to the borrower is that he does not receive value for any equity in the property in the event the value of the property foreclosed is higher than the outstanding debt. Strict foreclosure is not a commonly used method of foreclosure in either the U.S. or Europe. It is used in the U.S. usually in limited circumstances, usually when the property is abandoned or the borrower has little equity in the property.

The most common method of foreclosure in the U.S. is judicial foreclosure. Although details vary from state to state, generally the process begins with a judicial trial to allow both parties to present their positions. If the lender wins, a court order is granted to foreclose. An independent appraisal and title search are performed on the property to make sure there are no title problems and to set a minimum bid for auction. Notice of the auction is sent to all interested parties and the public, followed by the auction sale and judicial confirmation of the sale to ensure that the sales price was reasonable. Both the lender and the borrower are generally allowed to bid at auction and in the vast majority of cases it is the lender who purchases the property at auction because there are no other interested bidders. Proceeds from the sale of a foreclosure are usually first used to pay the expenses associated with the auction, then to the lender, then to other lienholders, and finally, to the extent there is a surplus, to the borrower. The law may provide that the lender has the right to pursue a deficiency judgment against the borrower in the event the sale proceeds are insufficient to cover the outstanding debt.

Judicial sale is the lengthier and more expensive foreclosure method, but there are a number of advantages, particularly for the borrower, that make it the preferable method of

¹Act LIII of 1994 on Execution by Court art. 7(2) [hereinafter Hungarian Execution Law].

²Hungarian Civil Code art. 269 (1996).

foreclosure in the U.S. The sale is conducted under the supervision of the court, presumably providing more objectivity and fairness in the process, and the borrower has the right to bid for the property at auction. Working to the advantage of the lender is the right to pursue a deficiency judgment and the fact that the court's involvement may assist in resolving any disputes that arise about priority of liens.

Non-judicial foreclosure shares many of the characteristics of judicial foreclosure such as appraisal, notice to interested parties and the public, and auction sale, but allows lenders to initiate sale of the property without going through the expensive and lengthy process of a court trial. In the Hungary and Poland, as in the U.S., non-judicial foreclosure is permitted if certain conditions are included in the loan documents. In the U.S., the mortgage must contain an explicit provision which allows for power of sale without a court hearing in the event of default. In Poland, non-judicial foreclosure may occur if the parties consent to this method in the loan agreement. In Hungary, if the loan agreement is prepared by a public notary, foreclosure procedures may begin without a court order.³ If the loan agreement has not been notarized, the lender may go to court to obtain an order acknowledging the default without going through the process of a trial and then may initiate sale of the collateral. One factor impeding more widespread use of this method is that the fees for notarization are quite high. Where non-judicial foreclosure is permitted, if the borrower wishes to challenge the foreclosure, in both the U.S. and Hungary the onus is on the borrower to initiate the necessary court action.

Another important execution issue is the order in which debts are satisfied with the proceeds from sale of the property. One of the problems in some CEE countries is that there are several liens legally superior to the mortgage lien. In Poland, a lender's security interest may be realized only after a number of other debts are satisfied, in order: execution costs, alimony, labor and other employee dues, taxes, other outstanding loans whether secured by the property or not, and fees for perpetual usufruct of State Treasury or local government (gmina) land and buildings.⁴ The priority of tax liens is a particular problem in Poland because these liens need never be registered or otherwise disclosed until a foreclosure is underway, making it impossible for the lender to assess the risk that unpaid taxes will exceed the value of the secured property.

In Hungary, the order of debts to be satisfied is child support, other support, wage garnishments, court-mandated payments the result of criminal litigation, public dues (including taxes), and other claims.⁵ It is standard practice in the U.S. and Western Europe for taxes to occupy the top lien priority. However, permitting four or five categories of debt to occupy a lien priority superior to the mortgage increases the lender's risk of not realizing full loan recovery and is a definite disincentive to lending.

³Hungarian Civil Code art. 260(1).

⁴Civil Proceedings Code, art. 1025.

⁵Execution Law, supra note 1, art. 165.

Ability to Evict Borrower

From a lender's perspective there is little value in a property that can be foreclosed upon but not resold to another party free of inhabitants. An occupied property will depress the sales price at auction because the new owner will be forced to contend with the expense and trouble of evicting the borrower still in residence. Lenders are generally not interested in purchasing the property only to be a landlord to the borrower who remains in residence as a tenant.

Legally, the foreclosure of the mortgage loan means only that the borrower's ownership of the property and right to redeem the loan no longer exist. Eviction of the borrower is a separate legal process. The law may offer several alternatives. The law may provide that a court order sanctioning the foreclosure is sufficient grounds for the lender to obtain an order to evict. In other cases the order to foreclose and the order to evict are issued at the same time. The third scenario, and the most cumbersome process for the lender, is to pursue a separate legal action against the borrower-resident who refuses to vacate the property after a foreclosure order is issued. In practice, it is often best for the borrower and lender to work out an arrangement, each making concessions to the other, that the borrower will agree to vacate the property before foreclosure.

In many countries in CEE, even where the legal basis for foreclosure existed, the law excepted certain groups or mandated that the lender provide alternative housing to the evicted parties. In Hungary, Slovakia, Poland, and the Czech Republic the provision of alternative housing is no longer required.⁶ However, for social and legal reasons, eviction is still not generally pursued. In the Czech Republic, there is no requirement that the foreclosed property be vacant at the time of auction. Hungarian law requires the parties to stipulate in the loan contract that the property will be delivered to the lender vacant if the lender enforces the lien and the property is transferred to the lender.⁷

The above discussion focuses on a number of provisions that are necessary for workable foreclosure procedures. There are a host of other provisions, a discussion of which is too lengthy for this paper, that might be considered in designing systems that provide relative protections to borrowers and lenders. These provisions include: a *statutory right of redemption* allowing the borrower to pay off the debt during a defined period after foreclosure and sale and receive back clear title to the property; *statutory minimum starting prices* at auctions to ensure the property does not sell for substantially less than its market value; or an *acceleration clause* making the outstanding loan balance fully payable if the borrower fails to make mortgage payments when due.

IV. Conclusion

⁶In Hungary and the Czech Republic the law now states that the lender must provide "shelter," a much more flexible requirement than the provision of alternative housing.

⁷Hungarian Civil Code art. 48.

The outlook for strengthened housing loan recovery in CEE is certainly much brighter than it was only a couple of years ago. Significant legal and regulatory reforms have been implemented recently which have begun to grant adequate protections to housing lenders seeking to make loans in a market-oriented housing finance environment. Lenders across the region now have at their disposal more and stronger loan recovery tools than at any time in recent history. However, the implementation of these tools is largely untested and remains the next practical step for banks and legal systems.

Governments and financial institutions appear to have come to the conclusion that if a healthy and responsive housing finance sector is to develop, banks cannot be held financially responsible for the social welfare of their clients who may default. As a result, banks have had to institute more complicated and difficult loan qualification procedures, increasing the cost of finance for everyone who does qualify for a loan. The effect is to limit access to housing finance to only that narrow range of people who can satisfy all criteria for a loan. Continued support for strong loan recovery over time is one of the crucial ingredients to making housing finance, and thus housing itself, more affordable. This could be a valuable lesson in countries where the high cost of housing is a primary concern to policy makers as well as to substantial numbers of families seeking housing.

Comments on
AN OVERVIEW OF THE LOAN RECOVERY COLLOQUIUM

December 16, 1996

Thank you and good morning. I wish to add my welcome to that of Agnes Balazs and Ivan Tosics. But I must in fairness add also a warning. As you may have noticed from examining the agenda for the next two days, we have invited you here to work hard.

While there will be a lot of opinions and information offered by speakers up here, most of the time on the agenda is devoted to hearing from you and to special sessions where the members from each country will be asked to apply these ideas to their situation.

At the same time that I warn you about the work involved, I want to make it as clear as I can that this is important work, work which your countrymen will benefit from for years to come. In other words, it is the work of the angels.

Now, that may seem like an odd statement. Our task is to make sure that the "greedy" bank can get the money its due out of the poor suffering household borrower. This would be viewed by many as the work of the devil, not the work of angels.

I must admit that no one likes to play the role of the enforcer or collector. But the fact is that religions around the world have found it useful to have some kind of enforcement mechanism to discourage us weak human beings from sinning. Such punishments, whether in the form of burning in hell or coming back to live again as a toad, have been at least as useful in encouraging civilized and moral behavior as have the exhortations to love one's neighbor. Societies then take the next step and create legal systems designed to enforce laws and contracts between people.

The result is a society where people usually behave in a reasonable and constructive way towards each other. In such societies, people even are willing to entrust their precious savings to banks or other lending institutions, who in turn give these funds to borrowers who use them to get housing. The end result is wonderful for the general public. Instead of saving up over ten years or more to buy a house for cash, people are able to buy it today and enjoy it while they then save the amount over the coming ten years or more.

That brings me to my main point this morning. Throughout Central and Eastern Europe, young families are very anxious about how they will get their housing in the future, now that the state is no longer heavily involved in this process. As we all know, the key to their obtaining housing is to get a loan.

But one requirement for giving loans is for the lender to be very confident that it will get paid on time as agreed, at least 95 percent of the time. And the prerequisite for getting paid back is to have an effective and reliable system for loan recovery.

Speaking as outside observers, our perception is that none of the countries in which we work has established a system of loan recovery which is reliable enough. What do I mean by "reliable enough"? Am I referring only to systems like we have in the US, where it is possible for the borrower to end up on the street in 6 months after missing payments?

No, a reliable system can be much less harsh. It can allow extensive forbearance and rescheduling. It can allow for a court procedure of a year or two. What I mean by "reliable" is that, as a practical matter, the borrower knows that, for sure, he will be forced to pay or to lose the house, within some kind of reasonable time frame. I did not say that the borrower knew that he "could" lose the house, but that he "will" lose the house.

Why is it so important that this be a certainty? Because anything less than certainty will prompt the defaulter not to do everything possible to remedy the default.

The problem is that borrowers operate within something we call a credit culture, which is a subpart of the overall culture. The credit culture encompasses attitudes towards borrowing and towards repayment. And evidence from around the world is that, in the absence of certainty of enforcement of loan recovery, attitudes toward repayment evolve over time. Or should I say "dissolve" over time?

At this point in time, I think that 99 percent of the people taking out housing loans in your countries expect to do everything possible to repay them. But as time goes on, that resolve will melt in the face of financial and personal difficulties. If there are no consequences to default under those circumstances, the seriousness of the difficulties that will trigger a default will become less and less. Basically, borrowers will ask themselves, Why should they make great efforts to pay when others do not have to?

Every society has to decide for itself what is fair in this regard. As you will hear from experts from the US, France and Germany, the details of fair but reliable systems can be very different. But without a reliable system of loan recovery, lending for housing will never develop as it should. And the housing opportunities of thousands of your citizens will be significantly reduced.

Permit me to take one minute to emphasize this point. Effective loan recovery, while the ending point of the lending process, is the beginning point of a housing finance system. Lenders will only make long term loans if they can count on loan recovery.

They will be willing to lend to more people, not just the best risks, and lend them more funds, not just half or two-thirds of the price of a house, if the costs of default are certain. And the lenders charges and the costs of raising funds from savers and investors will be lower if the costs from defaults are certain and minimal.

So the work we are asking you to do the next two days is the work of angels. It is to listen and then discuss among yourselves how your country can best move towards a reliable system of loan recovery.

Our first topic is, What are the missing pieces, if any, of the legal and procedural structure needed for reliable loan recovery? Carol Rabenhorst of the Urban Institute will review the necessary ingredients of such a legal structure. Dr. Olga Hildebrand of the Ministry of Justice in Hungary will review the strengths and weaknesses of the system here in Hungary.

After a break for coffee, a panel of experts from Slovakia, Croatia, Poland, and Germany will make brief comments from the perspective of their countries. After this, we will break out into groups to discuss in detail the situation in each of the primary countries represented here, Hungary, Slovakia, and Croatia. We will follow a similar pattern as part of the other sessions.

While it is our belief that strong and effective legal recourse is a necessity, it is also only a starting point. The second session is about how, given the existence of the strong and effective legal recourse, can the banks achieve reasonable loan recovery without actually using the legal recourse? This is a compromise that many societies have reached, to give the lender a strong legal position which the lender is discouraged to use but is effective at encouraging cooperation from the borrower.

Thus, in the afternoon, we will hear from Mr. Denis Deletoille from France and Mrs. Mira Ercegovic from Croatia on the procedures followed in France and Croatia to encourage repayment without having to utilize the full force of the legal recourse available to lenders.

The third session, starting tomorrow morning, will look at ways that other countries have shifted the risks of loan recovery to third parties and whether this is an alternative approach for you to consider.

I will speak about the possibilities of having mortgage insurance or guarantees or other methods by which the government can reduce the risks to banks. Mr. Achim Duebel of Germany will discuss the German experience, with a focus on how the social safety net has allowed loan recovery to be facilitated in the former East Germany.

The fourth session will try to organize the results of these two days into an agenda for action back in your country.

I know I speak for all the outside experts here and for USAID in saying that we very much want to see the opportunities for people to borrow for housing be expanded in all of your countries. We also know that the process will differ from country to country. We look forward to helping you in any way we can to formulate realistic plans to strengthen loan recovery in each country represented here.

**REGIONAL COLLOQUIUM ON HOUSING LOAN RECOVERY
IN CENTRAL AND EASTERN EUROPE**

Topic 1:

**“Establishing the Legal Basis for Housing Mortgage Loan
Recovery”**

Presented by:

Carol S. Rabenhorst

Senior Legal Advisor

The Urban Institute

Washington, DC

December 16 -17, 1996

Budapest, Hungary

INTRODUCTION

Throughout Central and Eastern Europe, homeownership is becoming a hallmark of the transition from central or planned economy to market-based economies. Some families are building their first homes, others are improving their existing homes, or trading up to larger homes. Central governments are transferring ownership of the state or socially owned multifamily housing stock to the citizens through mass privatization programs.

The countries undergoing economic restructuring in the post-socialist era have found housing to be critically important to this difficult transition. To a large extent, the attitudes of people about their overall quality of life reflect their level of satisfaction with their living conditions. Because no other sector directly affects the lives of such a large portion of the population, housing has profound political and social importance as well as economic implications.

In both Western Europe and the United States, government agencies have played a significant role in helping more families achieve homeownership by increasing the availability of mortgage financing. They encourage home ownership both because it is politically popular and because it contributes significantly to the economy as a whole. Lenders aggressively pursue the residential borrowing market because it is regarded as profitable and secure.

Costs of Default

Unfortunately, not all mortgage loans are repaid. Rates of default – that is, failure to repay the mortgage loan – vary significantly with the type of loan and the individual attributes of the borrower, in addition to external or macro-economic conditions.

Mortgage default is very expensive for the whole housing finance system. For lenders, and the institutions that guarantee and insure home mortgage loans, costs include the administrative and legal expenses of trying to collect loans in default, and the loss incurred when the net cash recovered from a foreclosure sale is less than the value of the property that is used as collateral.

A borrower who defaults also suffers losses, including a lower credit rating, legal expenses, lost work time and the emotional distress of dealing with legal proceedings, and ultimately the loss of his property.

There can be collective loss to the system. When there is a high level of mortgage default, mortgage borrowing becomes more expensive or may even cease to be available at all.

Minimizing default loss serves the interests not only of lenders, borrowers, and government agencies, but also the many private businesses and services that depend on a vibrant, smooth functioning real estate market.

Lenders' Choices

When a mortgage loan is in default, lenders have a number of choices available to them. They can simply wait to see if the borrower begins to pay again, they can attempt to negotiate with the borrower to attempt to resolve the problem, or they can initiate one or more of the legal remedies available under the law and the relevant loan documents.

Lenders choose from among these options, and decide how long to wait before acting, on the basis of business judgment. For example, if the lender determines that the borrower has a good credit record and is not paying because of a temporary illness or financial setback, the lender can decide to renegotiate the terms of the loan in a way that

allows the borrower to recover and resume payments. If the lender decides that the borrower's ability or willingness to pay is not likely to change in the near future, the lender can pursue various legal remedies, including collection from third-party guarantors, attachment of the wages of the borrower, or foreclosure and sale of the mortgaged property to recover the unpaid mortgage balance, interest, and

The relative merits of these different options must be examined by evaluating the amount of time, expense, and difficulty involved in implementing each of them, and the likelihood of success each of them provides in recovering all, or at least a substantial part, of the money owed to the bank.

To make an appropriate business judgment, the lender must be familiar with the legal framework applicable to mortgage lending and debt collection, since this is a critical factor in deciding which option to pursue.

WHY IS A STRONG LEGAL FRAMEWORK NECESSARY?

Strong Laws Are a Backstop for Nonpayment

We all know that the legal framework is an essential component of the entire mortgage lending system, yet we also know that mortgage finance is predicated on the assumption that a very large percentage of borrowers will repay their loans. This apparent contradiction can be resolved if you think of the legal framework as the "backstop" or the "last resort" in the process. In an ideal world, lenders would never have to use it. But the world is not ideal, defaults do occur, and sometimes legal action must be taken.

Strong Laws Deter Nonpayment

The legal framework is important as a backstop, but perhaps it is even more important to have a strong legal framework as a deterrent to loan default. If the borrower knows he must pay or the bank will have the power to take part of his wages or even take away his home, he will do everything possible to avoid a default. On the other hand, if

he knows the goal of the legal system is to protect his individual interests and to keep him in his home, even at the expense of all the other parties involved, the borrower will have little incentive to pay other than his own good intentions. This was one of the reasons for failure of housing finance systems in CEE under the old social

There are many positive attributes of a market-based system, but we know that the current transition places many demands on the pocketbook of the average person, threatens employment stability, and offers many tempting ways to spend money. So even a borrower's good intentions may not be enough to keep his loan payments current. The legal system must help to assure that mortgage borrowers repay their loans so that credit will be available and affordable for many people.

Weak Laws Increase the Cost of Loans

In addition to assessing the strength of the legal framework to choose from among their options when a loan is in default, lenders look at the strength of the legal framework to evaluate their credit risk in making a mortgage loan. If the framework is weak, banks must compensate for the increased risk by increasing the cost of the loan to the borrower. If the risk is very great, the lender may be forced to charge such high rates of interest that the loans become unaffordable to most people, or may refuse to make mortgage loans at all.

NECESSARY COMPONENTS OF THE LEGAL FRAMEWORK

Over the next two days, we will be talking about laws and procedures relating to recovery of loans in default, particularly about laws that are specific to the countries you represent. I will not go into detail about these laws, but would like to give you a very general overview of the categories of laws relating to mortgage lending and the purposes they serve, to set the stage for the more detailed and specific discussion

The basic legal framework for mortgage lending consists of three categories of laws.

Enabling Laws

The first are the enabling laws. These laws provide that a mortgage is a property right that can be used to secure a lender's claim for payment of the debt. Enabling laws give the owner the ability to use his property as collateral to obtain a loan. They often include provisions for the protection of the borrower, such as the requirement that the lender honestly disclose the terms of the loan and manage the basic transaction in an open and transparent way. They also provide the lender with strong security because of the ability to place a lien on immovable property, and the option to seize and sell the property if the borrower defaults on loan payments.

Registration Laws

In the second category are laws relating to creation and administration of a system for real property registration. These laws provide for a system of records demonstrating ownership or title, and the existence of other interests or property rights affecting the real property, including mortgages, other liens, easements, servitudes, and the like. Property records do not just indicate ownership or other facts about real property; they usually constitute legal evidence of ownership and the existence of other interests, including a lender's security interest.

The law must provide clear, efficient titling and registration procedures to show the actual legal status of each property at any given time. There must be public access to these legal records, the information and its significance must be transparent, and the records must be accurate, reliable, and up to date.

Enforcement Laws

The third category are laws relating to enforcement of mortgage obligations. These laws regulate the procedures under which the lender may pursue remedies for default, including access to the collateral or other assets of the borrower. Often, they also regulate the costs and expenses likely to be incurred in pursuing these remedies. These laws should include clear, efficient foreclosure procedures, so that in the event

of default the lender can acquire access to and use of the property that was used to secure the loan. They must enable the lender to evict the borrower after foreclosure so the property can be sold free of occupants.

Enforcement laws set out the priority of liens if there is more than one. Since priority may be based on factors others than sequence of registration, the registration records themselves might not establish the priority. It is important that the law provide the mortgage lender with a reasonable position in the order of payment from the proceeds of the sale of the mortgaged property or other assets of the borrower.

PROGRESS IN REFORMING THE LEGAL FRAMEWORK IN CEE

Pre-transition Legal Issues

In the early 1990s, international donors conducted a number of studies of the housing finance systems in CEE as part of their efforts to assist with the transformation to a market-based economic system. We learned that the planned economies were stable from a macro-economic standpoint, and financial terms for housing loans were soft, with long repayment terms and deeply subsidized interest rates.

Lenders making residential loans did not rely only the property itself as security for the loan in case of default, but were far more likely to use remedies such as garnishment of the borrower's wages and collection from guarantors., including garnishment of the guarantor's wages. Because the lender was the state, and the largest employer was the state, there was essentially a closed system in which wage garnishment was quite effective in collecting from borrowers in default. In addition, the law often afforded the state the privilege of garnishing wages without a court procedure, so the process could be accomplished easily and quickly. True mortgage financing was not necessary and rarely used.

The macroeconomic factors underlying that system are no longer present, and the countries in transition are looking toward housing finance systems based on the principles of a market economy. By going back to the early studies, we see two recurring

conclusions about the suitability of the legal framework for housing finance in a market economy. The first is that the pre-transition laws allow a borrower to use his property as collateral to secure a housing loan; in other words, mortgage lending was a legal possibility. The second is that other pre-transition laws, regulations, and firmly entrenched practices made security for mortgage loans so weak that true mortgage lending was simply not feasible from a market standpoint.

There were several basic reasons for the conclusion that market-based mortgage lending was not feasible under the old laws. The first is that in almost all cases, foreclosure and execution of a mortgage loan involved a very long, expensive judicial procedure, or even a series of procedures. The prospect of being tied up in court for several years made foreclosure an extremely unattractive option to lenders. Second, even if the lender were willing to endure the cost and time consumption of court, and succeeded in obtaining a transfer of title to the property, meaningful access to the property so it could be sold could still remain a long way off.

In order to evict the borrower, the lender had to initiate additional execution procedures (sometimes involving additional court hearings), and had to provide the evicted family with alternative housing. Just this one requirement – the notion that the lender had to have a stock of housing units to hand over to borrowers who default on mortgage loans – probably discouraged a lot of lenders from entering the housing loan market.

Recent Changes

Through a lot of careful thought and hard work, the most serious impediments to mortgage lending have been eliminated in most countries in the region. Over the next two days, we will be hearing a lot about the status of laws in the countries you represent, so I will not go into detail about specific changes in individual countries at this time. However, I am pleased to be able to say that as a result of these changes, the major *legal* obstacles to mortgage lending are gone.

The most significant changes include the following:

- The requirement for a judicial proceeding before sale of the property by the lender has been eliminated by recently enacted laws in Hungary, Slovakia, Croatia, and Poland. This is true as long as the loan documents are prepared in accordance with procedures mandated in the new laws.
- The requirement that a lender provide alternative housing when evicting a borrower after foreclosure has been eliminated in almost all circumstances in all of these countries.
- Steps have been taken to improve the speed and cost-effectiveness of execution procedures. Execution procedures in Slovakia, Hungary, and Croatia have been streamlined under enforcement laws adopted in the last year or so.
- Efforts are underway to improve the speed and accuracy of the titling and registration system. In general, most countries in the region have adequate, if antiquated, pre-war registration systems. The problems are more administrative than legal in nature, and will take time and a great deal of money to resolve. Donors from a number of countries are assisting with computerization of the systems and training of personnel.

LOAN RECOVERY IN EUROPEAN COMMUNITY COUNTRIES

Speakers from France and Germany will discuss loan recovery issues in their countries later in the program. I do want to mention that there is a very detailed comparative survey of foreclosure procedures in EC countries available (in English only) for those of you who would like to review it.

Basically, that study finds that procedures in use in EC countries are not uniform but share sufficient fundamental similarities to make cross-border transactions feasible. The EC recognizes that preserving fair competition in among mortgage lenders may justify the lack of perfect uniformity in treatment of creditors from one EC country to another.

Improvements are believed to be needed in the form of measures at the national level to reduce the length of time required to complete involuntary sales, and more congruence in the length of enforcement procedures would be desirable. Length of typical procedures range from one year in UK and Ireland to 3 years in Spain and as much as 5 years in Italy.

The study also recommends that mortgage registration systems be harmonized, with greater accuracy and accessibility of information. The difference in registration procedures is particularly problematic in the case of “hidden” or nondisclosed interests such as tax liens, which may take priority over a mortgage in distribution

As a side note, nondisclosed tax liens are a problem that is receiving considerable attention in Poland at this time.

The EC study also recommends that there be more uniformity in systems of distribution of proceeds after a forced sale, and that consideration be given to making a provisional payment to the first mortgagee before the sale procedure is complete, particularly in countries where the proceedings are especially protracted

ALTERNATIVES TO FORECLOSURE AND EVICTION

Despite recent changes in the legal systems in Central and Eastern Europe which facilitate foreclosure and eviction, most mortgage lenders continue to rely primarily on alternative measures to collect from borrowers in default. There may be cultural or social reasons for this preference, as well as weaknesses under old laws. It may also be that procedures for foreclosure and eviction are still perceived to be too lengthy and expensive, even under new laws designed to protect the lender's interests and expedite the process. In any case, our investigations indicate that these new legal measures remain largely untested.

At this colloquium, we will learn more about administering the collection process in your respective countries, and how you use techniques within the existing framework that can help make mortgage lending successful and profitable. We also hope to learn

more about your experience with foreclosure and eviction, and what your attitudes are about these remedies.

Whatever remedy may be most appropriate under the circumstances, it is important for the loan documents to include the lender's right to pursue the full range of remedies permitted under the law, so that the choice remains the lender's to make, and so that the threat of foreclosure and eviction can remain a deterrent to the borrower's continuing default or refusal to comply with renegotiated terms.

Alternatives other than foreclosure and eviction include:

Forbearance and Renegotiation of Loan Terms

Forbearance in taking legal action or renegotiation of loan terms may be considered when the borrower is experiencing temporary financial difficulties due to illness, unemployment, or other similar problems.

Under forbearance, the borrower and lender enter into a written agreement to suspend or reduce payments due for a temporary period. The agreement must make it clear that the debt is not waived, merely delayed to allow the borrower to get back on his feet. When the forbearance period ends, the borrower must pay the debt accrued during the period, usually by increasing monthly payments for a period of time.

When a loan is renegotiated, the lender may agree to lower the interest rate or monthly payment, extend the period of repayment, or modify the mortgage instrument itself, for example, by changing from fixed to variable rate, which may result in a lower rate for a period of time. Alternatively, the lender may allow the borrower to capitalize delinquent payments into the outstanding loan balance.

Voluntary Sale of Property

Voluntary sale of the property may be considered when a lender concludes that the borrower is not likely to recover from a financial setback and will not be able to meet

his mortgage obligations in the foreseeable future. In such a case, the borrower may agree voluntarily to sell the property and to undertake the necessary steps and incur the expenses of marketing and selling the property. Sales proceeds are turned over to the lender to satisfy the remaining debt. The seller retains proceeds in excess of the debt. If the sales proceeds are less than the outstanding debt, the lender may accept the sales price in satisfaction of the debt, or the borrower may remain liable for the difference, to be collected through other available remedies for collection of a debt.

Assumption of the Mortgage and Ownership by a Third Party

The lender and borrower may agree that ownership of the property and outstanding obligations under the mortgage will be transferred to a third party. If a willing and qualified third party can be found, this can be less costly and quicker than a voluntary sale.

Deed in Lieu of Foreclosure

A procedure called "deed in lieu of foreclosure" occurs when the borrower transfers title to the lender to satisfy the outstanding debt. Again, this is quicker and less expensive than foreclosure. If there are junior lienholders, they may need to be satisfied before this procedure can be used. Another disadvantage for the bank is that it must maintain and market the property.

Garnishing Wages

Garnishing wages is a familiar mechanism for loan recovery in the region. It may be less effective than in the past, because real wages remain relatively low and employment stability is no longer assured, and because a court procedure may be needed before wages can be garnished.

Third-Party Guarantors

Many lenders continue to require a number of third-party guarantors for mortgage loans. This spreads the risk beyond the borrower himself. The disadvantage is that the lender still may need to use court action to gain access to the assets of the guarantors, which can be time consuming and costly.

CONCLUSIONS

- Housing finance plays an important role in the political and economic well-being of a country.
- The cost and consequences of mortgage default can be reduced by the existence of a strong legal framework.
- Countries in the region have made substantial progress in improving laws relating to enforcement of the rights of mortgage lenders, including elimination of the requirement of a judicial procedure before foreclosure and the need to provide alternative housing to an evicted borrower.
- Despite these changes, lenders will continue to use other alternatives to collect loans in default.
- Countries in the region will continue to harmonize their laws and practices with those of Western Europe and they move toward cross-border transactions and strive for membership in the European Community.

ESTABLISHING THE LEGAL BASIS FOR HOUSING LOAN RECOVERY

- INTRODUCTION -

- **ROLE OF HOUSING IN THE ECONOMIC TRANSITION IN CEE**
- **COSTS OF DEFAULT**
 - **Costs to lender**
 - **Costs to borrower**
 - **Costs to the housing finance system**
 - **Costs to other businesses and services**

-

LENDERS' CHOICES

- **Wait and see**
- **Negotiate**
- **Take legal action**

WHY IS A STRONG LEGAL FRAMEWORK NECESSARY?

- **STRONG LAWS ARE A BACKSTOP FOR NONPAYMENT**
- **STRONG LAWS ARE A DETERRENT TO NONPAYMENT**
- **WEAK LAWS INCREASE THE COST OF LOANS**

NECESSARY COMPONENTS OF THE LEGAL FRAMEWORK

- **ENABLING LAWS**

- Real property can be used as collateral for a loan
- Mortgage is a property right that can secure a debt
- Lender has a right of access to the property in case of default
- Borrower protection (disclosure laws)

- **REGISTRATION LAWS**

- Evidence of ownership or title
- Evidence of existence of other interests, including mortgage
- Indicate actual legal status of property
- Public, transparent, accurate, reliable, up to date

- **ENFORCEMENT LAWS**
 - **Procedures for pursuing remedies for default**
 - **Regulate costs**
 - **Foreclosure and eviction procedures**
 - **Priority of liens**

PROGRESS IN REFORMING THE LEGAL FRAMEWORK IN CEE

- **PRE-TRANSITION LEGAL ISSUES**
 - Mortgage lending was possible, but rarely used
 - Other security was adequate
 - Legal framework for mortgage lending was very weak
- **BASIC WEAKNESSES IN THE LEGAL FRAMEWORK**
 - Foreclosure & eviction required long, costly court procedures
 - Evicted borrower entitled to alternative housing
- **RECENT CHANGES**
 - Elimination of judicial procedure requirement

- **Elimination of alternative housing requirement**
- **Increased speed & lower cost of execution procedures**
- **Efforts underway to improve registration procedures**

LOAN RECOVERY IN EC COUNTRIES

- **NOT UNIFORM, BUT FUNDAMENTALLY SIMILAR**
 - Cross-border transactions are possible
 - Lack of uniformity helps preserve fair competition
- **IMPROVEMENTS NEEDED**
 - Reduce time needed for foreclosure and execution
 - Harmonize registration systems
 - Restrict “hidden” or nondisclosed liens
 - Harmonize priority of liens and distribution of proceeds

ALTERNATIVES TO FORECLOSURE AND EVICTION

- **FORBEARANCE AND RENEGOTIATION OF LOAN TERMS**
- **VOLUNTARY SALE OF PROPERTY**
- **ASSUMPTION OF MORTGAGE AND OWNERSHIP BY THIRD PARTY**
- **DEED IN LIEU OF FORECLOSURE**
- **GARNISHING WAGES**
- **THIRD-PARTY GUARANTORS**

CONCLUSIONS

- **HOUSING FINANCE PLAYS AN IMPORTANT ROLE IN THE POLITICAL AND ECONOMIC WELL-BEING OF A COUNTRY.**
- **THE COSTS AND CONSEQUENCES OF MORTGAGE DEFAULT CAN BE REDUCED BY THE EXISTENCE OF A STRONG LEGAL FRAMEWORK.**
- **CEE COUNTRIES HAVE MADE SUBSTANTIAL PROGRESS IN IMPROVING LAWS RELATING TO ENFORCEMENT OF THE RIGHTS OF MORTGAGE LENDER.**

- **DESPITE THESE CHANGES, LENDERS WILL CONTINUE TO USE ALTERNATIVES TO FORECLOSURE AND EVICTION.**
- **COUNTRIES IN THE REGION WILL CONTINUE TO HARMONIZE THEIR LAWS AND PRACTICES WITH THOSE OF WESTERN EUROPE AND THE EUROPEAN COMMUNITY.**

**Causes and Consequences of
Residential Mortgage Default in Germany**

**Prepared by
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**Prepared for the
Regional Colloquium on Housing Loan Recovery
in Central and Eastern Europe**

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INTRODUCTION

I.

With the introduction of the social market economy in Germany after WW II, a dense social net has been created that also comes into play in the mortgage default situation. With reunification on Oct 3, 1990, all respective legal provisions were extended to the area of East Germany. Today, there is an interlinking net of regulations and laws that govern all the relevant issues such housing policy, bank underwriting behaviour, unemployment insurance, welfare payments, housing allowances for homeowners, foreclosure and forced sales, as well as consumer bankruptcy.

Many of these economically relevant features are subject to change right now, as austerity pressure is mounting as a consequence of the burden of reunification and the EMU treaty. However, in the case of mortgage default, mostly the size and length of transfers is affected; radical reform of the social system, as undertaken in the US under the past administration, is perhaps still to come. For the discussion here it is assumed - somewhat heroically - that the system will remain intact in its present structure. Major structural reform is only expected, and will be described below, for consumer bankruptcy.

RESIDENTIAL MORTGAGE DEFAULT - WEST AND EAST GERMANY

I.

Residential mortgage default is not well covered by research in Germany. Several indicators suggest however that default levels were rather low in the past in West Germany in international comparison. East Germany, where residential mortgage has not really started before 1993, is starting to show higher default rates. There are numerous indicators of loan default, that are best compared in Europe to the British data¹.

- Interest rate arrears over 30 days: In Germany, residential mortgage lending interest arrears of mortgage banks for 1990-1993 averaged only 0.1% or 10 bp² of the outstanding, volumewise. Again, figures for other lenders would be higher, perhaps in the range of 30 bp. For the UK, available casewise data would suggest much higher levels - in 1991 the country saw the worst arrears with 8.4% of all mortgage loans. Building societies had average arrears of 60-70 bp during the 1980's. Volumewise arrears should be significantly lower than that, but very likely higher than the German figures.
- Court actions/forced sales: Pending forced sales cases in courts is the only readily accessible statistics in Germany that would cover the entire banking industry. Figure 2-1 shows the West

Data presented are mainly drawn from Verband deutscher Hypothekenbanken and Statistisches Bundesamt, Germany, and Building

Societies Association/Council of Mortgage Lenders and HMSO Department of the Environment, United Kingdom.

bp: „basis points“, or hundredths of a percentage point.

German numbers of forced sales¹ per 1,000 inhabitants (average .78 per 1,000 over 1982-1995, and .67 for 1987-1993); taking into account the low homeownership rate (41%) and the high share of households without mortgage debt (46%), the figures reached. 5.7 per 1,000 in 1993.² Data for the UK are only comparable to some degree; the closest would be the number of enterings into court actions. The average was here 2.17 per 1,000 inhabitants and 6.11 per 1,000 outstanding mortgages, during 1987-1993. This figure would be higher if referring to households with mortgage debt instead of number of mortgages.

Figure 2-2 shows that the relatively low 0.6 per 1,000 inhabitant forced sales figure for East Germany translates into a 12.5 (1994) and 14.5 (1995) per 1,000 figure for homeowners with remaining mortgage debt. Forced sales are therefore twice as high, a serious situation by German standards. All banking associations fail to disclose more detailed information, for instance on arrears; a poor internal statistical system contributes to the data problems. Only 2 to 4 years after mortgage lending business has taken off, these figures are likely to reflect both the higher default probability of unseasoned loans and a higher average default risk of lending in East Germany. Although it has never been studied in detail, there is clearly an indication for a higher general risk of lending.

- Losses: German mortgage banks have shown over the period of 1977-1991 an average loss of 4.7 bp (a twentieth of a percentage point), with a maximum of 11.8 bp, of the outstanding mortgage balance, although with a slightly rising trend.³ Again the qualifications for higher rates with other, less conservative, lenders apply. No separate data on East Germany are available. Davis (1993) shows that write-offs for house purchase loans of a British clearing bank were in a similar range, averaging only 5-6 bp over the period of 1976 to 1991, with a maximum of 25 bp. However, in 1992/1993 write offs have risen dramatically, at least for the case of Building Societies (47 and 63 bp respectively).

DETERMINANTS OF MORTGAGE DEFAULT AND UNDERWRITING BEHAVIOUR

-

Market shocks - unemployment, house prices and interests

..

Forced sales would also include a presumably low, but unknown, percentage of non-home sales.

There are no reliable time series on the number of mortgage loans, nor the number of homeowners, in Germany. Data stem from the Income and Expenditure Survey 1993.

While mortgage banks are portfolio restricted - on average they cannot lend more than 75% loan-to-value - individual loans cover the whole range of loan-to-values.

The triggers for mortgage arrears and possessions are both discrete shocks and cyclical fluctuations of core economic factors that determine affordability and profitability of being a homeowner:

- unemployment and other causes for unanticipated drops in earnings (eg. failed self-employment) that cause affordability problems;
- breakdown in relationships and other social causes that reduce both the affordability and the utility derived from the property;
- general financial factors that determine the market value of the equity that the borrower has in the property, and hence of his „default option“. The main factors are the relation between the current interest rate and the mortgage contract interest rate, the general rent level for alternative housing, and the capital gain derived from the investment (house price). A related factor is the seasoning of the loan which determines the amount at which the outstanding balance has been reduced since loan underwriting.

Figure 3-3 shows the relation between forced sales and the unemployment rate in West Germany over time. Unemployment and, strongly correlated with that failed small businesses, are clearly major source of residential mortgage default.

Despite of the absence of any surveys, it is certain that unemployment is a major driving force of defaults in East Germany as well: the June-1996 unemployment rate was 14%, total underemployment 24%. This results in 10% of the labour force being employed through government-sponsored labour market measures (so-called „second“ labour market). However, as with other items of the social safety net, the „second“ labour market is at present strongly reduced, and unemployment therefore rising.

The classical explanations of residential credit default would look at financial factors that are determining the economic value of the so-called „default option“. The term option means that, in principle, every borrower has the option to give the home to the mortgage lender, if financial conditions become too adverse to continue paying the mortgage. This can easily be the case if the market value of the house is less than the present discounted value of the loan. As a result, the relative development of house prices, interest rates and market rents for private rental housing are decisive for the value of the default option.

Figure 3-4 shows that forced sales have not only correlated with unemployment, but also with a stagnating house market approaching zero capital gains and declining interest rates. Here a decisive difference between Germany, the UK and the US matters. In the US fixed-rate contracts are prepayable. This implies that the borrower can take advantage of an interest rate decline by refinancing for a lower interest rate, against payment of a higher general interest rate level. As a result, default risk is lowered to some extent, whereas affordability in general is worsened, through the general higher interest rate level. In the UK, the main financing method is adjustable-rate. Therefore, all interest rate increases are associated with higher defaults. A totally different pattern of default emerges than in Germany, where

defaults are low in the interest rate peak and vice versa. This is mainly due to the fact that mortgages in Germany are generally non-prepayable, increasing default risk as the next interest rate decline comes.

Loan underwriting

A.

The power of the described default triggers can be to a significant extent be influenced by the underwriting behaviour of the bank and the endowment of borrowers with equity.

Germany is traditionally a country with a low homeownership ratio (1995: 41.7% for West Germany and 26.4% for East Germany¹⁾) and one of the most conservative savings and loan underwriting behaviours in the world. The macroeconomic savings quota has hovered persistently around 12% for decades until it dropped somewhat with reunification, and the median household savings quota (from Income and Expenditure Survey 1993) is still above 8%.

In a survey undertaken by the author among mortgage banks in 1995 the median equity quota²⁾ of borrowers for new residential housing was 35% for West Germany, and 31% for East Germany. To see the real relations, it should be considered that the median house price in the survey was DM 470,000, and the median equity DM 156,000! East and West German clients of this banking group, besides, had a comparable income distribution, and comparable debt service ratios (37-40% of net family income). Outside the mortgage banks, borrower income, equity quota and house prices are certainly 20-30% lower, but equity quota below 20% are rare, and the „threshold“ income for becoming a homeowner is still well above DM 3,500/month, net of taxes and social security. Low equity is also punished as most lenders charge for a 50 bp risk premium for loan-to-value ratios between 60 and 80%, compared with a below 60% loan. Underwriters would also typically make a residual income calculation to arrive at the bearable debt service, regardless of the loan-to-value.

As a result, the first major cushion to mortgage default, loan underwriting remains extremely conservative. Of course, the system stands and falls with a sustainable property valuation technique, and a low property price risk environment.

That underwriting restrictiveness has something to do with credit default is a generally accepted paradigm³⁾ that has been particularly nicely shown for the US; Figure 3-5 shows the results of an analysis with 725,000 single-family loans that had been traced by Freddie Mac's chief economist, Bob Van Order (1990). The

For comparison, 1994: Hungary 86%, Russia 41%, Czech Republic 42.2%. 1990: United Kingdom 67%, France 60%, Italy 70%.

Including a low share of borrower work input (so-called „sweat money“).

For a good overview over the determinants of residential mortgage defaults in the US, see Quercia/Stegman (1992). For the UK, a recent

survey was undertaken by the Department of Environment (1995). For Germany there are no scientific writeups. Diamond and Lea (1992) have compared credit risk levels for four European countries.

data show that irrespective of a changing economic environment over time (interest rates, house prices etc..) default probabilities could be reduced by conservative underwriting.

The low German homeownership ratio is of course an unsatisfactory situation which has recently triggered numerous political initiatives. However, these are focussed on reducing house prices and increasing savings, not on increasing underwriting loan-to-values. To the present day there is no mortgage insurance industry in Germany. Housing policy has also in the past contributed to discouraging high-risk low-equity lending¹. This approach became untenable over time, however. Since January 1, 1996, Germany extends a 40,000 DM per head as an 8 year buy-in support to all prospective homeowners. As a result of lower income strata coming increasingly into reach of homeownership, credit risk is expected to rise over the next years, depending on whether banks become more aggressive among low-income borrowers.

SOCIAL SAFETY NET

I.

The most distinguishing feature that curbs residential mortgage default losses in Germany is a relatively low loss-per-default ratio, because loan rescheduling is frequent and foreclosure bears still sufficient lever for the lender. The social safety net is an important contribution to that.

The typical residential mortgage default scenario will be associated with a layoff. Table 4-1 that is derived from the OECD Economic Survey Germany (1996) compares wage substitution ratios (percentage of wage that is retained after becoming unemployed) after transfers and taxes internationally:

Table 4-1 Net Wage Substitution Ratios of Income for a Single-earner Household after Transfers and Taxes

Source: OECD Report Germany (1996). Notes: for details of calculation see the report.

For Germany the result is that the wage substitution ratio is rather high and will increase with housing allowances. The most important feature is the timing of transfers. German unemployed lose only 7% of their previous wage in the first five years of unemployment, while US unemployed lose 50%! As a result of the combination of high unemployment support and active regional and labour market policy, households are

This has been done by delinking fiscal support in most but a short phase in the early 1990's from the lending amount and focussing leverage

independent tax support to upper middle-income households. The independency from the leverage, but not the focussing on higher income strata, stands in stark contrast to the US where high loan-to-value lending supported by interest deductability, as well as the credit risk approach expressed in the FHA/SMM refinancing model, have contributed to the low national and household savings quota.

seldom forced to move, in particular if the spouse is still working. This is becoming an aspect in East Germany, where local unemployment rates reach 30%, without inducing major migrations!

The housing allowance variant for homeowners that is included in the aforementioned calculation is the „Lastenzuschuß“, which has a cap that depends on general housing costs in the region and household type. For a couple with two children, approx. 1,000 DM out of a, say 2,000 DM mortgage debt service, will be acknowledged in calculating the allowance. The Lastenzuschuß then would be about 400 DM, leaving a debt service of 1,600 DM. As most defaults occur between 3 and 5 years into the loan, when the outstanding is still higher than 95%, debt burdens after payment of Lastenzuschuß will typically be too high to avoid a default. The Lastenzuschuß is therefore a necessary, rather than a sufficient, factor in the default case. In general, the allowance is not designed for free market homeownership crisis management, but for ex-ante calculations for the homeownership form of social housing.¹

On top of wage substitution, in case of unemployment all general safety net measures remain intact; the most important being a child support of 220 DM/month per child (from 1997).

The combination of all these measures, the social safety net, makes loan rescheduling in many cases feasible, in particular if underwriting loan-to-value ratios had been conservative²³. Additional debt relief from the lender, especially refinancing of high interest fixed-rate mortgages into low interest fixed-rate mortgages, waiver of fees and maturity extension, will be however necessary. Prepayment is typically excluded in the mortgage contract in Germany. The lender will accept the incurred loss from rescheduling and prepayment as:

- first, a forced sales could potentially come along with significant costs as well, in particular the risk of a low claim recovery ratio.

Lastenzuschuß is de-facto only relevant for the so-called „1. Förderweg“ of social housing. Low-income households with a high number of

children and difficulties to find social rental accommodation are the typical target group. A capital subsidy, typically given by the land, the general federal homeownership support and the federal Lastenzuschuß combine to reduce the debt burden to minimal levels. The guillotine maximum debt burden is here not violated because the capital subsidy reduces the loan amount (while the federal homeownership program is only an interest-rate buy-in. Without the capital subsidy, Lastenzuschuß would play no practical role.

In the US, by contrast, rescheduling in case of unemployment is much more difficult, as a consequence of the rapidly decreasing wage substitution ratio. This would either

- force an unemployed into bankruptcy, constituting the classical default.
- force an unemployed to search for a new job, with often a higher debt-service ratio.
- force an unemployed to move in order to get a new job, leaving the sale of the house as the last resort to cover the outstanding debt

Exact data on the frequency of rescheduling vs. foreclosure are unavailable.

- second, for balance sheet reasons; an immediate default would force a write-off, while prepayment does not change the book value of the loan. Germany does, however, not know quarterly write-offs as the US; also possibilities for delay of write-offs are wider.

Banks will in cases of good prospects of rescheduling apply the same calculation method as for ordinary loan applications: they will calculate the residual income after mortgage payments which shall not drop below a certain level determined internally in the bank (eg. 1.500 DM net plus child allowances).

Rescheduling is more rare in the case of failed freelancers or small businesses because they typically have no unemployment insurance; here other creditors will seek bankruptcy, leaving no alternative to the lender than to foreclose. In a personal hardship case these persons will receive welfare aid, which is under all conceivable circumstances too low to service a mortgage credit. Here, the problem of high correlation between borrower bankruptcy and collateral price risk occurs which should cause banks to underwrite more cautiously from the beginning. That correlation is less in the case of a dependent employee, because of unemployment insurance.

Taken together, the social system actively supports the borrower in the case of mortgage default, except for the self-employed. This will in many cases not prevent a default in the case of unemployment, as the house-price-to-income relation is traditionally high and debt burdens might remain unaffordable with high transfers. Also, unemployment support is increasingly jeopardized by austerity policy, and long-term wage substitution rates will decline rather than rise. Still, however, German lenders will maintain their priority claim on the borrowers income for all amounts due, even after a foreclosure has taken place.

FORECLOSURE/CONSUMER BANKRUPTCY

I.

While the social system provides a positive environment for rescheduling of loans, the foreclosure and bankruptcy procedure is of mixed quality for the lender, who often will seek to avoid it altogether. There are additional problems in East Germany because of often unclear property titles.

If renegotiation fails, the mortgage is foreclosed on. Under present legislation there are two main positive features for banks:

1. the preferential ranking of mortgage claims in the bankruptcy case. Mortgage claims in Germany are not only first rank in the bankruptcy procedure, they are separated from the mass from which other creditors claims are saturated. As a result, claims of the government, of craftsmen, and even of dependents are all ranking behind the mortgage claim and a first rank lender has a powerful instrument. As the second mortgage is in many cases a Bauspar loan, mortgage banks and commercial banks enjoy additional protection (the Bauspar also contributes to a low default risk and high equity ratios, as it requires an extended, and subsidized, savings period).
2. If the sale of all assets of the borrower does not yield sufficient revenue, the priority of the mortgage claim is transferred to an indefinite claim against the borrower's income. The borrower's income may be seized down to the corresponding level of welfare payments (which is in turn rather high in the German case). The indefinite nature of the claim („debt tower“) stands in stark contrast to the

situation in other EU countries and the US, which know consumer bankruptcy. Germany is therefore about to introduce consumer bankruptcy in 1999. This will restrict the time period for which the household has to pay to a maximum of 7 years, after which full liberation of remaining debts will be granted.

From the creditor standpoint, all collateral, such as mortgages, reservation of proprietary rights and wage garnishment remain intact. As a result, banks may retain the entire residual income during the first three years. Hereafter it will be divided pro rata. Residual creditors such as craftsmen and spouses or children with maintenance claim are in a bad position, as accumulated claims extinguish after seven years.

On the negative side of the German legal solution stands the complexity of the foreclosure process. A lender with a notarial contract automatically has the right to foreclose; however, contrary for instance to the British system, there is no automatic transfer of ownership. Instead the judicial forced sales procedure must be activated, in which the lender may, or may not, acquire the full property title. This is of course a problem since without a full property title on the side of the lender, no court decision on vacating the premises can be reached. Without previous vacating, however, the sales price of the property may be too low to cover the claims of the lender, as court procedures on vacation typically take a year.

As a result, much depends on the cooperation of the borrower. The main lever of lenders in this negotiation process is his - soon to be reduced - capability of claiming residual outstanding indefinitely. Also, banks charge penalizing interests on contracts in breach of covenant. As a result, the borrower will pay in the future for non-cooperation in the sales process today. Under this threat the borrower will typically move voluntarily upon foreclosure, increasing the sales proceeds and minimizing his residual debt. The highly negative social stigmatization of borrowers in breach of covenants will contribute to that. In the cooperation case, the bank will typically give a grant period of 3 months to the borrower to achieve a non-judicial sale of the object.

ALTERNATIVE HOUSING/EVICTION

I.

Facing the threat of eviction, the availability of alternative housing comes into play. Germany has a high share of private rental housing (45% of housing stock) whose rent levels will typically be more affordable than the debt burden that the borrower had to pay before the default. As a result, voluntary vacation and cooperation in the sales procedure may result in a positive short-term financial outcome for an overleveraged borrower. The situation of alternative private rental housing is particularly unproblematic in East Germany, where special depreciation allowances of 50% of the construction costs over 2 years on top of the standard degressive depreciation have produced a rental housing boom over the past five years. Defaulters will be eligible for housing allowance, if the rent level proves to be too high.

Also, in hardship cases, local governments would have to pay welfare aid as well as provide the household with housing accommodation. This would typically take the form of transitory housing in hotels, hostels etc.. until social housing becomes available. Local governments are required by law to prevent homelessness.

CONCLUSION

I.

For transition countries the question arises whether the German model is transferable to their situation. As Germans have discovered now themselves, the social safety net is too costly to survive in an international labour cost competition. The past stability of residential mortgage lending is both a result of massive subsidies and a stable economic environment, both may be subject to change.

Disregarding the subsidy level for the moment, house price and interest rate stability that are a function of macroeconomic stability, seem to be the major economic factors. In this respect, the issue of prepayment becomes crucial for transition countries, who typically would expect strong interest rate declines.

Foreclosure and consumer bankruptcy must be efficiently organized; in terms of its convolutions and length, the German process is certainly not a model. In particular, in transition countries, transfer of ownership would have to take place before the forced sale. However, the strong position of the German mortgage lender in the bankruptcy case will be difficult to transfer to transition countries.

Finally, unemployment insurance, housing allowances, regional policy and labour market instruments that hinder large waves of internal migration are useful, although potentially extremely costly measures, that have proven their effects in particular in East Germany. The massive tax incentives that have led to a housing construction boom in East Germany which in turn eases the difficulties of eviction can certainly not be repeated in transition countries; low-cost social housing that caters evicted families might be an option.

I.

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Figure 2-1 Forced sales per 1,000 Inhabitants in West and East Germany

Source: Statistisches Bundesamt. Note: East Germany 1994 excludes Mecklenburg-West Pomerania.

Figure 2-2 Forced sales per 1,000 Homeowners and per 1,000 Homeowners with Mortgage Debt, East and West Germany

Source: Statistisches Bundesamt, Income and Expenditure Survey (EVS), author's calculations. Note: „West“ includes Berlin. „East“ excludes Mecklenburg-West Pomerania for 1994.

Figure 3-3 Forced sales per 1,000 inhabitants in West Germany and unemployment rate, 1980-1995

Source: Deutsche Bundesbank, Statistisches Bundesamt, author's calculations

Figure 3-4 Forced sales per 1,000 inhabitants in West Germany and Financial Determinants of Residential credit default, 1980-1995

Source: Statistisches Bundesamt, Bayerische Vereinsbank, author's calculation

Figure 3-5 Cumulative Default Probability of Single-family Residential Mortgage Cohorts within 10 years of Origination - US Data

Comments on the ALLOCATION OF RISK TO THIRD PARTIES

Yesterday we discussed the ways in which lenders can protect themselves from default on the part of borrowers. These were separated into (1) legal measures associated with pursuing the lien on the house or flat or some other piece of real property and (2) other measures to resolve the default that are internal to the lender.

These two areas of loan recovery are at the heart of making the system work well, potentially very well.

However, the discussion of loan recovery and managing default risk would not be complete if a third option were not also discussed, at least to a modest extent. That third option is to put all or a part of the default risk on a third party, i.e., someone other than the borrower or the lender.

This topic is important mostly because it is something that comes up frequently in conversations with officials in CEE countries. So we thought we would take the next couple hours to discuss it and see if it is relevant to any of your situations.

At the beginning, I have to admit that I doubt that any of these ideas are easily applicable in the Central and Eastern European countries at the moment. But I think it is important to know of their existence and if they might be useful in the future.

Guarantors

In theory, many CEE lenders already shift their risks to third party guarantors of the housing loan. These other private individuals undertake to make repayment if the original debtor defaults. In order to make this a credible alternative, the guarantors must have a high level of income and a low level of debt.

In practice, this process appears to not actually shift the credit losses to the guarantors, but to have more to do with screening out those with higher credit risks before they can even borrow and with exerting social pressure on borrowers. Only relatively substantial individuals can muster two or three other financially substantial friends to act as guarantors. By the same token, this step reduces the ability of many other households to access credit and the potential market for lending. But it probably is useful for generating the special attention to a short-term delinquency to prevent it from turning into a long-term default.

Mortgage Insurance

Of more substantive comfort to a lender is the presence of some kind of mortgage insurance or government guarantee that compensates the lender in case of loss.

Now I think that every lender in the CEE dreams of having access to mortgage insurance of the type that is heavily used in the US and UK. It sharply limits the potential losses and allows the lender to focus on the good parts of mortgage lending, the origination and servicing of the loan. But unfortunately that view is usually based on only a partial understanding of the way the system works.

In reality, there are two big problems with relying on a mortgage insurance system. The first drawback is that almost all mortgage insurance is based on the premise that the bank gets paid for the losses it bears after all is said and done with respect to foreclosure.

In other words, mortgage insurance does not relieve the lender of the burden of pursuing all legal recourse prior to collecting on the insurance. Thus, the presence of mortgage insurance will normally not reduce the difficulties posed by legal and administrative structures poorly designed to support foreclosure and eviction, nor the adverse publicity accompanying such actions.

In fact, mortgage insurance offered in the US and UK is built around the presumption that the risk being insured against is that the proceeds of the auction will not be enough to repay the loan. Mortgage insurance is never used unless there is a question as to whether the loan amount, plus interest and expenses, will be less than the likely value of the house upon foreclosure.

So traditional mortgage insurance does not solve the problem of enforcing liens. And, since in your countries, loans are rarely for more than two-thirds of the value of the house, if the lien can be easily executed, there will be no loss and thus no need for traditional mortgage insurance.

The second major limitation of mortgage insurance is that it introduces "moral hazard" into the loan origination and servicing process. "Moral hazard" refers to the incentive to "cheat" in some way or another that arises when the costs of such cheating are borne by another party while the benefits accrue to the cheater.

Insurance encourages lenders to originate and service loans less carefully, because they do not have to bear the full consequences. Because of this, the premiums paid to the insurance company have to be substantially larger than the expected amount of the losses that the lender would bear if they had no insurance. If so, it makes sense for the lender to keep the money and bear the risk themselves. And

in fact, that is exactly what happens in France and Germany. If people borrow more than two-thirds of the cost of a house, they pay a higher interest rate, which the equivalent to charging for mortgage insurance.

However, mortgage insurance is commonly used in the U.S. and the U.K., despite this extra cost. Why? The basic advantage of mortgage insurance is that it spreads default risks over a number of lenders and regions. This is especially important when a country has many small lenders operating in segmented regions. An unlucky series of events could drown such a lender, while a large lender lending everywhere in the country will usually have some good areas to counterbalance the bad ones.

There is one other possible reason why lenders may be willing to pay more than the expected amount of loss to get someone else to bear the risks. That reason is to avoid bad publicity from harsh loan recovery activities. If the insurance company is in a better position to bear that bad publicity, then there may still be room for making such insurance viable.

Government Guarantees

This reasoning has been used to suggest that the government get involved by guaranteeing loans. The view is that only the government can bear the burden of having to be harsh with defaulting borrowers. In a way, it seems similar to the way the governments have set up funds to take over the bad loans at the formerly state-owned banks.

Is it possible that a government-sponsored entity would be able to take a stronger stand on foreclosure or at least be in a better position to provide a social safety net of alternative housing or other assistance?

Here the answer comes from experience around the world and that answer is no. Everywhere from Chile to the US to Jordan and to the Philippines, government sponsored lenders have been proven to run their guarantee businesses into bankruptcy.

There are two reasons for this. The first is that the public has trouble believing that their elected representatives will be very harsh on them. The minute they doubt this, the moral hazard of the borrower increase and he is much less inclined to take extraordinary measures to avoid default.

This problem has been avoided in the US by requiring the lender to pursue all normal foreclosure processes before collecting from the insurance fund. But then the second problem kicks in, that is, that the political system will tend to undermine the guarantee from within. Forces will tend to cause the entity to offer too generous

coverage at too low a price.

The Social Safety Net

There is another, more practical way of shifting risks to third parties. This refers to the risks of the underlying causes of defaults, usually physical disability, unemployment, or family crisis. The nice thing about insuring against these problems rather than against default directly is that it tends to minimize the moral hazard, i.e., the borrower and lender benefit only if afflicted by some event outside their control, rather than just because the borrower decides to spend their money on a trip to the Riviera rather than pay the mortgage.

For example, it is possible to require life or disability insurance against physical illness or death. Most importantly, the government usually offers some protection against unemployment.

In those countries with the highest unemployment insurance, the payments are high enough to effectively cover the mortgage payment or at least allow the lender to arrange some easier payment pattern while the borrower is unemployed. Of course, this does not help in the case of self-employed people.

Some governments offer special assistance with mortgage payments. In addition, private insurers in Western Europe also offer mortgage payment coverage in cases of involuntary unemployment. Marital or other family crises are more difficult to indemnify against.

I say these are more practical because I see them in use in Western European countries. For example, I know that, at least a few years ago, lenders in France were pushing on their borrowers that they buy insurance that would pay the mortgage in case of unemployment. I don't know if the insurance companies have stopped offering that as the unemployment rate has risen.

Also in the UK and Germany, there are programs of special supplements to government payments made to the unemployed specifically for helping to pay the mortgage. I think Achim Duebel will talk about how that works in Germany in a few minutes from now.

Finally, I would note that it is possible to integrate mortgage payment support into a broader based housing allowance. This has most comprehensively been done as part of the social safety net in Germany. But housing allowances have been discussed in many of the CEE, mostly in the context of absorbing rent increases in the stock of social housing. But it could include a clause which includes assistance with mortgage payments if they exceed some share of household income, like 50 percent.

As you may know, the UK had a very bad situation with respect to default a

couple years ago. This was not because of particularly high unemployment, but mostly because loans were made as a very high proportion of house price and then house values fell very sharply. So many people owed more than the house was worth.

In dealing with this flood of foreclosures, there was cooperation between the government and the lenders, in order to not flood the market with sales and push down prices further. For those owners in bad financial condition, the government provided rental assistance so that they could rent the house from the bank, and not have to move out. If a general rental assistance program were set up in CEE countries, it could also be tailored to help keep defaulters in their house.

Conclusions

I have reviewed some additional ideas that you may have thought about before as means of dealing with default risks. I have been very critical of these ideas in general, both because I think they would not work and because I do not see them as substitutes for a legal and administrative system that keeps the pressure on borrowers to make their payments if at all possible or to sell out or to do whatever else is needed to repay the funds which were given them by the lender. No one is simply entitled to a loan to buy their own house, and the shirking of the duty to repay by anyone who could possibly avoid default is both unfair to all the borrowers who do repay and also tempting to those other borrowers to imitate.

The one approach that seems to have a role is private or government sponsored insurance against the exogenous problems that cause financial difficulties, but not against the loan losses themselves.

But I look forward to discussing these possibilities.